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## A STUDY ON RULE 145 OF THE SECURITIES ACT OF 1933: HOW TO PROVIDE CLARITY AND PREDICTABILITY IN RULE 145 TRANSACTIONS

*Kab Lae Kim*<sup>\*</sup>

### I. INTRODUCTION

Under the Securities Act of 1933 (hereinafter the 1933 Act),<sup>1</sup> an issuer must register or be eligible for an exemption from registration requirements to offer, sell, or deliver securities by jurisdictional means.<sup>2</sup> The costs of compliance with the disclosure requirements of the 1933 Act are high and exemptions from registration have marketing and liquidity restrictions.<sup>3</sup> Therefore, securities lawyers try to find loopholes to circumvent the 1933 Act's disclosure system.

In the late 1960's, securities practitioners devised and used some schemes abusing the "no-sale" theory,<sup>4</sup> such as a spin-off, to circumvent registration requirements under the 1933 Act. The Securities and Exchange Commission (hereinafter the SEC) supported the "no-sale" theory, embodying it in Rule 133.<sup>5</sup> In 1972, the SEC recognized the

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1. 15 U.S.C.A. § 77e et seq. (West 2006).

2. Jurisdictional means include "any means or instruments of transportation or communication in interstate commerce or of the mails." 15 U.S.C.A. § 77e(a) (West 2006).

3. Securities which are not sold in registered public offerings have limitations on manner of offering and restrictions on resale. That is, transaction exemptions contain prohibitions against general solicitation and general advertising (marketing restriction) and the subsequent public resales include the volume and manner of sale limitations (liquidity restriction). See J. William Hicks, *Protection of Individual Investors Under U.S. Securities Laws: The Impact of International Regulatory Competition*, 1 IND. J. GLOBAL LEGAL STUD. 431, 446-451 (1994) [hereinafter Hicks, *Protection of Individual Investors*] (discussing "limitations on manner of sale" and "resale restrictions").

4. See *infra* Part II.B.

5. 17 C.F.R. § 230.133 (1971) (rescinded by Release No. 5316, *infra* note 6).

loopholes exploited by the “no-sale” theory and adopted Rule 145, rescinding Rule 133.<sup>6</sup> Rule 145 requires registration and restricts resale of securities issued under a reorganization or recapitalization plan that is subject to security holders’ approval.<sup>7</sup>

Rule 145 has achieved mixed success. The SEC succeeded in abolishing the “legal formalism” of the “no-sale” theory by requiring the securities issued in certain recapitalizations or reorganizations described in Rule 145(a)<sup>8</sup> (hereinafter the Rule 145 transaction) to be subject to disclosure requirements. However, the Commission failed to make clear and predictable the registration requirements for the issuance and resale of securities in connection with a Rule 145 transaction. Rule 145 is complex<sup>9</sup> and incongruous with the general congressional intention of the 1933 Act. Thus, it involves the following theoretical and practical problems.

First, Rule 145(a) fails to provide a clear standard for determining whether a certain recapitalization or reorganization involves a sale to trigger registration requirements. In real practice, the concept of the “material change” in security holders’ rights has rightly served as a standard for the SEC to determine if there is a sale for the purpose of Rule 145.<sup>10</sup> However, the SEC has not codified the “material change” criterion.<sup>11</sup> The SEC has sometimes given priority to other policy considerations over the “material change” standard to determine the occurrence of a sale, which made the SEC’s interpretation of Rule

6. See SEC Securities Act Release No. 5316, 1972 SEC LEXIS 243, at \*1 (Oct. 6, 1972).

7. 17 C.F.R. § 230.145 (2006).

8. *Id.* at §230.145(a) (setting forth the types of transactions covered by Rule 145).

9. Professor Macey is very skeptical of complex rules and regulations under securities laws. He appropriately argues that complex and technical disclosure requirements led to Enron’s financial fraud. See Jonathan R. Macey, *Efficient Capital Markets, Corporate Disclosure, and Enron*, 89 CORNELL L. REV. 394, 421 (2004).

10. See, e.g., First Great-West Life & Annuity Insurance Company and Canada Life Insurance Company of New York, SEC No-Action Letter, 2005 SEC No-Act. LEXIS 860, at \*19 (Dec. 22, 2005); Sun Life Assurance Company of Canada (U.S.), Keyport Life Insurance Company, SEC No-Action Letter, 2003 SEC No-Act. LEXIS 825, at \*22 (Dec. 23, 2003); Rydex Advisor, SEC No-Action Letter, 1998 SEC No-Act. LEXIS 923, at \*12 (Sept. 29, 1998).

11. The codified “material change” standard will restrain both substantively and procedurally undue exercises of the SEC staff discretion in issuing no-action letters relating to Rule 145(a). The “material change” criterion will help keep Rule 145(a)-related no-action letters consistent with the general principle of the 1933 Act, the tenor of Rule 145, and related no-action letters. See Rutheford B. Campbell, Jr., *Rule 145: Mergers, Acquisitions and Recapitalizations under the Securities Act of 1933*, 56 FORDHAM L. REV. 277, 340 (1987) [hereinafter Campbell, *Rule 145*]. The criterion will also prevent the SEC staff from “creating substantive law [through the no-action letter process] . . . without any checks and balances which are inherent in our system of government.” Lewis D. Lowenfels, *SEC No-Action Letters: Conflicts with Existing Statutes, Cases and Commission Releases*, 59 VA. L. REV. 303, 321 (1973).

145(a) unpredictable and inconsistent. The SEC's ad-hoc approach without a clear standard for the concept of "sale" creates risks that the staff may define a transaction which is not "functionally equivalent to surrendering the old security for a new one"<sup>12</sup> as a "sale" or exclude a transaction resulting in a "material change" from the disclosure requirements of the 1933 Act.

Second, Rule 145(c)<sup>13</sup> and (d),<sup>14</sup> as special resale provisions for "securities acquired in a Rule 145 transactions" (hereinafter Rule 145 securities), are inconsistent with general resale provisions under the 1933 Act. The SEC's authority to establish Rule 145 was mandated by provisions of the 1933 Act.<sup>15</sup> Accordingly, the resale provisions of Rule 145 cannot deviate from the general resale rules under the 1933 Act.<sup>16</sup> Whereas general provisions of the 1933 Act define the term "underwriter" focusing on investment intent, Rule 145(c) imposes underwriter status focusing on control relationship. There is no legislative ground for the different definition of "underwriter" from the general definition of the 1933 Act. The "statutory underwriter" of Rule 145(c) unreasonably restricts the resale of Rule 145 securities.

Finally, ambiguous and inconsistent SEC interpretations concerning Rule 145 impede efficient market pricing and increase transaction costs. Basically, market liquidity for securities maintains the efficiency of stock pricing.<sup>17</sup> Trading restrictions on "presumptive underwriters" defined in Rule 145(c) decrease the market liquidity for Rule 145 securities and, accordingly, the reduced liquidity obstructs fair pricing of the securities. Also, the SEC has overly relied on "no-action letters,"<sup>18</sup>

12. JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 399 (5th ed. 2006) (citing SEC v. Associated Gas & Electric Co., 99 F.2d 795 (2d Cir. 1938)) [hereinafter COX ET AL., SECURITIES REGULATION].

13. 17 C.F.R. § 230.145(c) (2006).

14. *Id.* at § 230.145(d) (providing a safe harbor for unregistered resales by Rule 145 affiliates).

15. Section 19(a) states that "[t]he Commission shall have authority from time to time to make, amend, and rescind such rules and regulations as may be necessary to carry out the provisions of this title . . . ." 15 U.S.C.S. § 77s (LexisNexis 2006).

16. Interpretive rules "cannot impose obligations on citizens that exceed those fairly attributable to the legislature through the process of statutory interpretation." 73 C.J.S. *Public Administrative Law and Procedure* § 168 (2006) (citing U.S. v. Yuzary, 55 F.3d 47 (2d Cir. 1995)).

17. "Increased liquidity improves market efficiency . . ." Jonathan R. Macey, et al., *Restrictions on Short Sales: An Analysis of the Uptick Rule and its Role in View of the October 1987 Stock Market Crash*, 74 CORNELL L. REV. 799, 811 (1989).

18. "A no-action letter is one in which an authorized staff official indicates that the staff will not recommend any enforcement action to the Commission if the proposed transaction described in the incoming correspondence is consummated." SEC Securities Act Release No. 6253, 1980 SEC LEXIS 443, at \*1 n.2 (Oct. 28, 1980).

instead of interpretive releases, as guidelines in the interpretation and application of Rule 145. The legal ambiguity and unpredictability caused by the loose issuance of SEC no-action letters confuses business planners of Rule 145 transactions. Therefore, securities lawyers representing issuers in Rule 145 transactions try to seek comfort with more no-action inquiries, creating vicious circles of no-action letters, which increases costs of Rule 145 transactions. High costs of Rule 145 transactions may hamper the efficient allocation of economic resources through recapitalizations or reorganizations.

The above-mentioned problems with Rule 145 appear at every stage of a Rule 145 type transaction: reckless issuance of no-action letters at a business planning stage, inconsistent standards for determining a “sale” at a registration stage, and over-extension of the “underwriter” concept at a resale stage. This article will analyze problems shown in every stage of a Rule 145 transaction.

## II. SALE OR NO-SALE ARGUMENT

### A. *Why Sale or No-Sale Matters*

A “sale”<sup>19</sup> is a threshold requirement for the registration and prospectus delivery under Section 5 of the 1933 Act.<sup>20</sup> In connection with reclassifications and reorganizations, the preliminary note to Rule 145 of the 1933 Act characterizes a “sale” as a transaction involving a “new investment decision” of security holders.<sup>21</sup> To provide securities holders with information for making well informed sell-hold-buy decisions, the term “sale” triggers the registration and prospectus requirements.

Whether there is a sale or not, shareholders may receive material information under the proxy rules. Even if there is a sale, however, the proxy rules do not apply to companies whose securities are not

19. Section 2(a)(3) of the Securities Act of 1933, a definition section, provides “[t]he term ‘sale’ or ‘sell’ shall include every contract of sale or disposition of a security or interest in a security, for value.” 15 U.S.C.A. § 77b(a)(3) (West 2006) (emphasis added).

20. 15 U.S.C.A. § 77e (West 2006).

21. Preliminary Note to Rule 145 states:

[A]n *offer*, *offer to sell*, *offer for sale*, or *sale* occurs when there is submitted to security holders a plan or agreement pursuant to which such holders are required to elect, on the basis of what is in substance a new investment decision, whether to accept a new or different security in exchange for their existing security.

17 C.F.R. § 230.145 (2006) (emphasis added).

registered under Section 12(g) of the 1934 Act<sup>22</sup> and some state laws do not require a shareholder approval of a certain recapitalization or reorganization. In those cases, the registration and prospectus delivery under the 1933 Act may be the only disclosure requirements for security holders to make well-informed investment decisions.

A “sale” is also a prerequisite to limitations on resale of securities derived from the nature of a transaction exemption.<sup>23</sup> The nature of a sale determines whether the securities issued are restricted or unrestricted. For example, if an investor acquires securities in a private placement, the securities will be restricted.<sup>24</sup> If a non-control person acquires securities in a registered public offering, the securities will be unrestricted. If an investor receives securities in a transaction involving “no-sale,” however, the transaction is neutral to the status of securities<sup>25</sup> and new securities acquired in the no-sale transaction succeed to the status of the surrendered securities.

Accordingly, in order to resell the securities acquired in a “no-sale” transaction, securities holders must find out the status of the underlying stocks which were exchanged for new securities. If the underlying stocks were unrestricted, the recipients of the new securities can freely resell them to the public. Conversely, if the underlying stocks were restricted, the new shareholders are subject to restrictions on resale to the public. Thus, to avoid the risk of illegal distribution of unregistered securities, a would-be seller must cautiously decide if his or her acquiring of securities involved a “sale.” Whether there is a sale or no-sale matters to protect public investors from the secondary distribution through the abuse of a “no-sale” rule.

The above-mentioned disclosure issues at both primary and secondary distribution stages are the concern of Section 5. Another primary concern of the 1933 Act is to “prevent frauds in the sale” of securities.<sup>26</sup> The “sale” concept also triggers the anti-fraud and civil

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22. 15 U.S.C.A. § 78n (West 2006); *see also* 15 U.S.C.S. § 78l (LexisNexis 2006); 17 C.F.R. § 240.12g-1 (2006).

23. *See* J. WILLIAM HICKS, *RESALES OF RESTRICTED SECURITIES* § 2:7 (2006), *available at* WESTLAW, SECRESR § 2:7 [hereinafter HICKS, *RESALES*].

24. *See* 17 C.F.R. § 230.144(a)(3) (2006) (defining the term “restricted securities”).

25. In other words, restricted securities stay restricted and unrestricted securities remain unrestricted as results of transactions involving no-sale. *See* Campbell, *Rule 145*, *supra* note 11, at 316-17.

26. *See* the Preamble to the Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (1933) (stating that purpose of Securities Act of 1933 is “[t]o provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in sale thereof”).

liability provisions.<sup>27</sup>

### B. *The No-Sale Theory*

An exchange or alteration of outstanding securities in a business combination, reorganization, or a similar transaction requiring the authorization of security holders seems to be somewhere between a sale and a no-sale. On one hand, it is not shareholders' volitional actions, but a corporate action, that converts outstanding securities into new securities in a business combination submitted to a shareholder vote or consent.<sup>28</sup> That is, a shareholder vote only triggers operation of law which then makes a security transaction effective.<sup>29</sup> In such a case, there is "no sale" and the shareholder vote is only subject to proxy disclosure requirements.<sup>30</sup> On the other hand, however, if we focus on the whole process of the business combination transaction including the issuance of new securities, we can consider a proposal for the transaction submitted to security holders' authorization as an "offer to sell" under Section 2(a)(3) and Section 5 of the 1933 Act. Consequently, there is a sale involved in the reorganization plan and the security holders receiving new securities under the plan are entitled to disclosure required by the 1933 Act.

The "no-sale" theory is based on the assumption that a shareholder vote for a certain corporate reorganization does not involve individual investment decisions, but only a shareholder authorization of corporate action,<sup>31</sup> so the transaction includes "no sale" and requires no registration. At an early stage of the 1933 Act's enactment, the SEC tended to deal with the business combination under the "no-sale" theory<sup>32</sup> and then required neither registration nor limited resales by the

27. See generally J. WILLIAM HICKS, CIVIL LIABILITIES: ENFORCEMENT AND LITIGATION UNDER THE 1933 ACT (2006), available at WESTLAW, SECCIVIL §§ 1:1-7:35.

28. See J. William Hicks, *The Concept of Transaction as a Restraint on Resale Limitations*, 49 OHIO ST. L.J. 417, 455 (1988).

29. Shareholder's volitional act is the key element of a "sale." So, if a unanimous shareholder approval is required for a transaction, it involves a "sale." Also, if control shareholders of a target company negotiate a security transaction with an acquiring company and the shareholder vote is only a matter of formality, there is a "sale." See Note, *Business Combinations and Registration Requirements: Rule 145*, 47 N.Y.U. L. REV. 929, 932 (1972) [hereinafter *Business Combinations*].

30. See generally THOMAS LEE HAZEN & DAVID L. RATNER, SECURITIES REGULATION: CASES AND MATERIALS 162-65 (6th ed. 2003) (explaining the proxy rules in the context of the Securities Law of 1934).

31. Rutheford B. Campbell, *Resale of Securities Under the Securities Act of 1933*, 52 WASH. & LEE L. REV. 1333, 1363 (1995) [hereinafter Campbell, *Resale*].

32. At the beginning stage of the 1933 Act, the Federal Trade Commission functioning as a predecessor of the SEC treated the issuance of securities in a business combination taken through

recipients of new securities.<sup>33</sup> In 1951, the SEC adopted Rule 133 under the 1933 Act, embodying the “no-sale” theory in it.<sup>34</sup>

### *C. The Abuse of Rule 133 and Amended Rule 133(c)*

Since the adoption of Rule 133, the SEC had been troubled by unregulated resales of securities acquired in transactions within the meaning of Rule 133 (hereinafter Rule 133 securities).<sup>35</sup> Under the “no-sale” theory embodied in Rule 133, a reorganization or recapitalization submitted to security holders’ approval (hereinafter Rule 133 transaction) did not involve a sale.<sup>36</sup> Thus, it was theoretically hard to impose an underwriter status on a Rule 133 security holder because a recipient in a Rule 133 transaction did not “purchase” securities with a view to distribution within the meaning of Section 2(a)(11) of the 1933 Act. Accordingly, resales of Rule 133 securities could easily be interpreted as “transactions by any person other than an issuer, underwriter or dealer”<sup>37</sup> within the meaning of the Section 4(1) trading exemption.<sup>38</sup>

Some private companies abused Rule 133 to “go public” without registration under Section 5 of the 1933 Act.<sup>39</sup> As the public distribution of unregistered securities through the abuse of Rule 133 gave rise to serious problems, the court and the SEC started amending the “no-sale” rule. In *SEC v. Micro-Moisture Controls, Inc.*, the Southern District Court of New York did not apply Rule 133 to the case in which the exchange of assets for stock was only “a step in the major activity of selling the stock.”<sup>40</sup> Also, in *Great Sweet Grass Oils, Ltd.*,<sup>41</sup> the SEC

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shareholder vote as involving a sale and required Form E-1 for the registration. *See generally* SEC Securities Act Release No. 167, 1934 SEC LEXIS 79 (May 18, 1934). *But see* SEC Securities Act Release No. 493(Class C), 1935 SEC LEXIS 716 (Sept. 20, 1935) (supporting “no-sale” theory). *See also* William H. Heyman, *Implications of Rule 145 under the Securities Act of 1933*, 53 B.U. L. REV. 785, 786 (1973) [hereinafter Heyman, *Implications*].

33. *See* HICKS, *RESALES*, *supra* note 23, at § 3:18.

34. *See* SEC Securities Act Release No. 3420, 1951 SEC LEXIS 23 (Aug. 2, 1951).

35. It might be because Mergers and Acquisitions had increased since Rule 133 was adopted. Through the misuse of Rule 133 in those transactions, many private companies wanted to “go public without the expense, disclosure and potential liability involved in registration.” *See* Heyman, *Implications*, *supra* note 32, at 786-87.

36. Campbell, *Resale*, *supra* note 31, at 1363.

37. 15 U.S.C.A. § 77d(1) (West 2006).

38. Section 4(1) of the 1933 Act excludes ordinary market trading from the 1933 Act disclosure requirements.

39. *See infra* Part IV.C.3 (explaining the “spin-off” scheme).

40. *SEC v. Micro-Moisture Controls, Inc.*, 148 F. Supp. 558, 562 (S.D.N.Y. 1957).

41. *In re Great Sweet Grass Oils, Ltd.*, 37 S.E.C. 683 (1957), *aff’d per curiam*, 256 F.2d 893 (D.C. Cir. 1958).



ruled that Rule 133 would not be applicable to a case where there was “a pre-existing plan . . . to use stockholders merely as a conduit for distributing a substantial amount of securities to the public”<sup>42</sup> or “the persons negotiating an exchange, merger or similar transaction have sufficient control of the voting stock to make a vote of stockholders a mere formality . . . .”<sup>43</sup> The Commission also ruled that the Section 4(1) exemption would not be applicable if “the issuer or persons acting on its behalf participate in arrangements” to distribute Rule 133 securities to the public.<sup>44</sup>

In 1959, the SEC amended Rule 133 by adopting Rule 133(c) and Form S-14.<sup>45</sup> In Rule 133(c), the Commission defined as an “underwriter” any constituent corporation or any person who was an affiliate of a constituent corporation at the time of voting and acquired securities of the issuer in connection with Rule 133 transaction with a view to distribution. However, Rule 133(c) was still based on the “no-sale” theory.

#### *D. The Sale Theory and Rule 145*

Rule 133(c) defined affiliates of any party to a Rule 133 transaction at the time of voting as underwriters within the meaning of Section 2(a)(11) of the 1933 Act to limit the resale of unregistered Rule 133 securities.<sup>46</sup> However, the term “underwriter” as defined by Section 2(a)(11) was premised on the occurrence of a “sale,”<sup>47</sup> while Rule 133(c) was based on the “no-sale” theory. Thus, there was a contradiction that the “underwriters” within the meaning of Rule 133(c) were deemed to have “purchased” securities for purposes of Section 2(a)(11), but were deemed to have “not purchased” securities for purposes of Section 5

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42. *Id.* at 690.

43. *Id.* at 691.

44. *Id.* at 690.

45. *See generally* SEC Securities Act Release No. 4115, 1959 SEC LEXIS 320 (July 16, 1959).

46. *Id.* at \*3-4. Amended Rule 133(c) provided:

Any constituent corporation, or any person who is an affiliate of a constituent corporation at the time any transaction specified in paragraph (a) is submitted to a vote of the stockholders of such corporation, who acquires securities of the issuer in connection with such transaction with a view to the distribution thereof shall be deemed to be an underwriter of such securities within the meaning of section 2(11) of the Act. A transfer by a constituent corporation to its security holders of securities of the issuer upon a complete or partial liquidation shall not be deemed a distribution for the purpose of this paragraph.

*Id.*

47. *See infra* Part V.B.

registration requirements.<sup>48</sup>

Also, Rule 133(c) focused not on the purchaser's lack of investment intent, but on the control relationship with a party to a Rule 133 transaction. Once you had been an affiliate of an acquired company at the time of the vote for a Rule 133 transaction, you could not resell Rule 133 securities even if you became a non-affiliate of an acquiring company. The rule engendered unfair results. First, if you had not been an affiliate of the acquired company, you could have resold as many Rule 133 securities as you wanted without registration.<sup>49</sup> Second, if you had acquired securities in a voluntary exchange, you could have resold the unregistered securities irrespective of the control relationship with your company, if not a presumptive underwriter of selling securities.<sup>50</sup>

The logical inconsistency and practical unfairness of Rule 133(c) put the SEC in the crossfire of criticism from security lawyers and legal scholars. In 1969, a special study of disclosure problems under the 1933 and 1934 Acts, prepared by the SEC staff under the supervision of then-Commissioner Francis M. Wheat (the "Wheat Report"),<sup>51</sup> pointed out the "disclosure gap" in deciding on a business combination and the unfair resale limitation posed by the underwriter definition under Rule 133(c).<sup>52</sup>

In 1972, reflecting recommendations made in the Wheat Report, the SEC adopted Rule 145 and simultaneously rescinded Rule 133, stating that "[f]ormalism should no longer deprive investors of the disclosure to which they are entitled."<sup>53</sup> Rule 145 is based on the idea that, given "the substance of the transactions specified therein"<sup>54</sup> and "the fundamental nature of the relationship between the stockholders and the corporation,"<sup>55</sup> there is a "volitional act on the part of the individual stockholder required for a 'sale'"<sup>56</sup> in a Rule 145 transaction. Therefore, there is a need for investor protection by means of disclosure.<sup>57</sup>

48. See *Business Combinations*, *supra* note 29, at 941.

49. See HICKS, REALES, *supra* note 23, § 3:18 (citing Throop, *Recent Developments with Respect to Rule 133*, 15 BUS. LAW. 119, 122 (1959)).

50. See *Business Combinations*, *supra* note 29, at 941-42.

51. See SEC Securities Act Release No. 4963, 1969 SEC LEXIS 686, at \*1 (April 14, 1969).

52. See Heyman, *Implications*, *supra* note 32, at 788-91 (quoting SEC, *Disclosure to Investors: A Reappraisal of Federal Administrative Policies under the '33 and '34 Acts* (Disclosure Policy Study, 1969)).

53. SEC Securities Act Release No. 5316, *supra* note 6, at \*6-7.

54. *Id.* at \*5.

55. *Id.*

56. *Id.* at \*4.

57. Bruce Alan Mann, *Rule 145 and Section 3(a)(9) of the Securities Act of 1933*, 700 PLI/Corp 575 [hereinafter Mann, *Rule 145*]. A securities law practitioner states:

Rule 145 was adopted in 1972 to eliminate the difference between the disclosure

However, Rule 145 failed to eliminate all the problems arising from the “no-sale” theory. For example, Rule 145(c), based on the “sale” theory, regulates the resale of “registered” securities in a similar manner as Rule 133(c) based on the “no-sale” theory did. This vestige of “no-sale” theory in Rule 145 still creates many theoretical and practical problems.

### III. RULE 145 AND ITS DISCLOSURE SYSTEM

#### A. General Understanding of Rule 145

Generally, the provisions of Rule 145 consist of three sections. First, Rule 145(a) sets forth certain types of recapitalizations and reorganizations and subjects them to the registration requirements under Section 5 of the 1933 Act.<sup>58</sup> Second, Rule 145(b)<sup>59</sup> deals with the prior announcement concerning a Rule 145 transaction providing some relaxation of conventional “gun-jumping” prohibitions.<sup>60</sup> Lastly, paragraphs (c) and (d) of Rule 145 cover the resale restriction on the registered securities issued in a Rule 145 transaction.<sup>61</sup>

Rule 145(a) requires registration of securities issued in a non-exempted Rule 145 transaction using the term “sale” as a triggering event. Form S-4 is designed for a certain business combination and mostly used for the registration of Rule 145 securities.<sup>62</sup> As a Rule 145 transaction requires registration, it is also subject to the “gun-jumping” prohibition under Section 5(c) of the 1933 Act. To give a safe harbor from the “gun-jumping” prohibition, Rule 145(b) excludes certain limited announcements of a business combination from the definition of an offer to sell or a prospectus under the 1933 Act.<sup>63</sup>

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obligations and protections afforded by the 1933 Act in stock for stock acquisitions and in mergers, consolidations and acquisitions of assets. . . . Since January 1, 1973, mergers, consolidations and sales of assets followed by liquidation have been treated in a manner similar to a stock-for-stock exchange.

*Id.*

58. 17 C.F.R. § 230.145(a) (2006).

59. *Id.* at § 230.145(b).

60. Gun-jumping is an illegal attempt to condition the market for future sales. *See generally* Eric A. Chiappinelli, *Gun Jumping: The Problem of Extraneous Offers of Securities*, 50 U. PITT. L. REV. 457 (1989).

61. 17 C.F.R. § 230.145(c), (d) (2006).

62. Subcommittee on Annual Review, *Annual Review of Federal Securities Regulation*, 40 BUS. LAW. 997, 1008 (1985).

63. Rule 145(b) states, “Communications made in connection with or relating to a transaction described in paragraph (a) of this section that will be registered under the Act may be made under [Rule 135, Rule 165 or Rule 166].” 17. C.F.R. § 230.145(b) (2006).

Rule 145(c) and (d) deal with the resale of Rule 145 securities. Rule 145(c) imposes underwriter status on any party to a Rule 145 transaction, other than the issuer, or any person who is an affiliate of such party when the transaction is submitted for security holders' authorization.<sup>64</sup> Rule 145(d) excludes from underwriter status any person defined as an underwriter by Rule 145(c) in the following three circumstances: (1) When the securities are sold in accordance with the Rule 144 requirements, excluding the holding period and notice filing requirements;<sup>65</sup> (2) When the seller who is a non-affiliate of the issuer has held the securities for at least one year and the issuer meets the information requirements of Rule 144;<sup>66</sup> or (3) When the seller who is a non-affiliate of the issuer has held the securities for at least two years and has not been an affiliate within the last three months.<sup>67</sup>

### B. Form S-4

Form S-4 is the registration form of securities to be issued in connection with following transactions: (1) Rule 145 type transactions; (2) Mergers without "the solicitation of the votes or consents of all of the security holders of the [target] company" under the applicable state law; (3) Exchange offers for securities of the issuer or another entity; (4) Public reoffers or resales of any securities acquired according to Form S-4; and (5) More than one of the above-listed transactions registered on one registration statement.<sup>68</sup>

Form S-4, as a successor to Form S-14,<sup>69</sup> is based on the idea that "decisions made in the context of business combination transactions and those made otherwise in the purchase of a security in the primary or trading market are substantially similar."<sup>70</sup> Form S-4 adopts the "S-1-2-3 approach."<sup>71</sup> The preparation of Form S-4 depends on whether the company is a Form S-1, Form S-2, or Form S-3 registrant:<sup>72</sup> Form S-4

64. 17 C.F.R. § 230.145(c).

65. 17 C.F.R. § 230.144(c), (e), (f), and (g) (2006).

66. *Id.* at § 230.144(c), (d).

67. *Id.* at § 230.144(d).

68. 17 C.F.R. § 239.25 (2006).

69. Form S-4 replaced Forms S-14 and S-15 in 1985. SEC Securities Act Release No. 33-6578, 1985 SEC LEXIS 1687 (Apr. 23, 1985). *See also* SEC Securities Act Release No. 33-6611, 1985 SEC LEXIS 2477 (Nov. 22, 1985) (rescinding Form S-14 and adopting Form N-14); SEC Securities Act Release No. 33-6579, 1985 SEC LEXIS 1688 (Apr. 23, 1985) (adopting Form F-4 for foreign issuer's registration of securities to be issued in certain business combinations).

70. SEC Securities Act Release No. 33-6578, *supra* note 69, at \*9.

71. *Id.*; *see* Bruce Alan Mann, *Rule 145 and Form S-4*, 609 PLI/Corp 733.

72. Form S-1 is the basic form for registration containing complete information on the issuer

allows the incorporation of certain information by reference according to “Form S-1-2-3 criteria.”

The security holders’ decision on a business combination involves fewer volitional acts than other investment decisions. Form S-4 identifies the difference between business combination decisions and other purchases of securities.<sup>73</sup> Form S-4 provides special provisions to reflect the special nature of a business combination transaction. All Form S-4 prospectuses include particularly tailored information for a business combination.<sup>74</sup> Also, the Form requires the prospectus containing information incorporated by reference to be delivered to shareholders at least 20 business days in advance of the date of their investment decision.<sup>75</sup>

Form S-4 reflects the integrated disclosure system<sup>76</sup> to relieve the burden of disclosure on issuers and to give potential buyers simplified and streamlined information for their investment decisions excluding unnecessarily voluminous information. When adopting Form S-4, the Commission pointed out that “the documents delivered to security holders in the context of business combinations (mergers and exchange offers) are frequently unwieldy, often 150 or more pages.”<sup>77</sup> Form S-4 integrates prospectuses under the 1933 Act and proxy statements and periodic reports under the 1934 Act. When a business combination transaction is subject to both Form S-4 under the 1933 Act and the proxy rules of Regulation 14A under the 1934 Act,<sup>78</sup> any proxy statements in Form S-4 will satisfy the requirement of the 1934 Act filing.<sup>79</sup>

Form S-4 consists of two parts.<sup>80</sup> Part I contains information required in the prospectus which is divided into four sections: (1) information about the transaction, (2) information about the registrant, (3) information about the company being acquired, and (4) voting and

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and transaction in the prospectus. Form S-2 requires less disclosure and Form S-3 requires the least amount of disclosure. 17 C.F.R. §§ 239.11-.13 (2006).

73. See SEC Securities Act Release No. 33-6578, *supra* note 69, at \*9-10.

74. See Simon M. Lorne & Joy Marlane Bryan, ACQUISITIONS AND MERGERS: NEGOTIATED AND CONTESTED TRANSACTIONS § 3:39 (2006), available at WESTLAW, SECACQMERG § 3:39.

75. *Id.*

76. See SEC Securities Act Release No. 33-6578, *supra* note 69, at \*3 (“Form S-4 employs the principles underlying the integrated disclosure system . . .”).

77. See *id.* at \*5.

78. 17 C.F.R. §§ 240.14a-1 to .14b-1 (2006) (providing detailed rules as to the steps to be followed in connection with proxy solicitation).

79. *Id.* at § 240.14a-6(j) (stating merger proxy materials).

80. See U.S. Securities and Exch. Comm’n, Form S-4 (Registration Statement Under Securities Act of 1933), available at <http://www.sec.gov/about/forms/forms-4.pdf> (last visited Oct. 25, 2006).

management information.<sup>81</sup> Part II requires information not required in the prospectus relating to indemnification of directors and officers, exhibits and financial statement schedules, and undertakings.<sup>82</sup>

Thanks to the integrated disclosure system underlying Form S-4, issuers in Rule 145 transactions can reduce disclosure costs. For example, in a Rule 145 merger transaction, the issuer does not have to pay the fee for filing the proxy solicitation under Regulation 14A if a registration statement on Form S-4 is filed.<sup>83</sup> However, securities market participants think that the filing of a Form S-4 registration statement is expensive and time-consuming: legal and accounting fees, printing costs, and filing fees total more than \$250,000; moreover, the SEC's review takes several months.<sup>84</sup> Consequently, many securities practitioners are still looking for the exemptions from registration to reduce compliance costs.

### *C. Shareholder Communications in Rule 145 Transactions*

Rule 145 subjects certain business combination transactions to Section 5 of the 1933 Act. Section 5(a) prohibits the sale of securities until a registration statement is in effect.<sup>85</sup> Section 5(c) prohibits all oral and written offers in advance of the filing of a registration statement.<sup>86</sup> In a Rule 145 transaction, offerees are the shareholders of the company involved. Thus, any communication with the shareholders as to the proposed transaction poses a risk of constituting an "offer" within the meaning of Section 2(a)(3).<sup>87</sup>

To obtain shareholder approval of a certain business combination plan, an issuer needs to notify its shareholders of the proposal or the shareholder meeting prior to the filing of a registration statement. On its face, it may be viewed as "gun-jumping" that violates Section 5(c). Rule 145(b) associated with Rule 135, Rule 165, and Rule 166 relaxes the gun-jumping restrictions.<sup>88</sup>

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81. *Id.*

82. *Id.*

83. 17 C.F.R. § 240.14a-6(j)(2) (2006).

84. See Thomas R. Taylor & Bradley R. Jacobsen, *M&A Transactions under Utah's New "Fairness Hearing" Statute*, 16 UTAH BAR J. 24, 26 (2003) [hereinafter Taylor & Jacobsen, *M&A*].

85. 15 U.S.C.A. § 77e(a) (West 2006).

86. *Id.* at § 77e(c).

87. *Id.* at § 77b(a)(3) (defining an offer as "every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value").

88. 17 C.F.R. § 230.145(b) (2006) (providing that communications in connection with a Rule 145 transaction "that will be registered under the [1933] Act may be made under [Rule 135, Rule 165 or Rule 166]").

Rule 135 prevents the announcement of a Rule 145 transaction prior to the filing of the S-4 registration statement from being deemed an “offer.” The exempted communication, for example, in the form of a press release, must include no more than: (1) The names of the issuer and “any other parties to the transaction;” (2) “A brief description of the business of the parties to the transaction;” (3) “The date, time and place” of the security holder meeting; and (4) “A brief description of the transaction and the basic terms of the transaction.”<sup>89</sup>

Rule 135 limits the content of communication to the basic announcement of a planned business combination and substantially eradicates Section 5(c)’s concerns about gun-jumping. As the prior notice of a business combination plan will not be deemed to be an “offer,”<sup>90</sup> it is not subject to the anti-fraud liability under Section 12(a)(2) of the 1933 Act.<sup>91</sup>

Even though a Rule 135 notice is not viewed as preconditioning the market for the securities to be issued, it arouses the interest of market participants. Given the highly technical and complicated reality of today’s financial market, many analysts and shareholders, especially institutional investors, have strong desires to know about the reason for the proposed business combination and its anticipated effects before they are available for Form S-4 or a joint proxy statement/prospectus. Sometimes, the acquiring companies face the necessity of disclosing some information during the pre-filing or pre-effectiveness period when the stock prices fall significantly on worries about coming business combinations.<sup>92</sup> Recognizing this problem, the SEC adopted Regulation M-A and Rules 162, 165, 166 and 425 to relax communication restrictions in connection with business combinations.<sup>93</sup>

Rule 165 creates a safe harbor for a business transaction against the “gun-jumping” prohibition.<sup>94</sup> Rule 165 exempts “free writing” during post-filing period<sup>95</sup> and “prior notice” during pre-filing period from

89. *Id.* at § 230.135(a)(2)(viii)(D).

90. *Id.* at § 230.425(b).

91. *See* 15 U.S.C.S. 77l(a)(2) (LexisNexis 2006).

92. *See* LOU R. KLING & EILEEN T. NUGENT, *NEGOTIATED ACQUISITIONS OF COMPANIES, SUBSIDIARIES AND DIVISIONS* § 5.02 (2006) (stating that “[o]ften, companies, particularly acquirors, that failed to provide the information found that the trading price of their stock dropped significantly”), *available at* WESTLAW, NACOMP § 5.02.

93. *See* SEC Securities Act Release No. 33-7760, 1999 SEC LEXIS 2291 (Oct. 22, 1999).

94. 17 C.F.R. § 230.165 (2006).

95. In the so-called Aircraft Carrier Release, the SEC showed its belief that “the waiting period [that is, post-filing period] should be a time of open dialogue between the registrant and its potential investors, provided that the registrant is accountable for the accuracy and completeness of its communications.” SEC Securities Act Release No. 33-7606A, 1998 SEC LEXIS 2858, at 254

Sections 5(b)(1) and (c) if the prospectus is promptly filed with SEC under Rule 424<sup>96</sup> or 425<sup>97</sup> and contains a legend to remind the investors to read the SEC-filed documents. Rule 166 exempts from Section 5(c) any communication in advance of the first public announcement of a business combination, provided that “the participants take all reasonable steps within their control to prevent further distribution or publication of the communication until either the first public announcement is made or the registration statement related to the transaction is filed.”<sup>98</sup>

Although communications in reliance on the above-mentioned exemption provisions are exempted from “gun-jumping” restrictions, some communications are subject to anti-fraud liability under Section 12(a)(2) of the 1933 Act.<sup>99</sup> The SEC worries that strict application of anti-fraud liability under the 1933 Act would cause a chilling effect on all the communications relating to business combinations. Accordingly, Section 12(a)(2) applies when business combination-related communications constitute “offers,” which, the SEC believes, can strike a balance between investor protections and free communications.<sup>100</sup> Whereas Rule 135 notices are excluded from the term “offer” within the meaning of Section 2(a)(3), communications pursuant to Rule 165 constitute “offers” and are therefore subject to Section 12(a)(2) liability under the 1933 Act.

As Rule 145(b) applies only to a business combination-related communication, it does not alleviate “gun-jumping” prohibitions in connection with general capital-raising transactions. The preliminary notes to Rule 165 or 166 do not permit the exemption when the primary purpose of the transaction is to condition the market for future sales in spite of technical compliance with the safe harbor rule.<sup>101</sup> This business purpose test is another effort by the SEC to protect investors without chilling business combination transactions.

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(Nov. 13, 1998).

96. 17 C.F.R. § 230.424 (2006).

97. *Id.* at § 230.425.

98. *Id.* at § 230.166.

99. 15 U.S.C.A. § 77l(a)(2) (West 2006).

100. See SEC Securities Act Release No. 33-7760, *supra* note 93, at \*37-43.

101. The preliminary notes state that “[t]he exemption does not apply to communications that may be in technical compliance with this section, but have the primary purpose or effect of conditioning the market for another transaction, such as a capital-raising or resale transaction.” 17 C.F.R. §§ 230.165-.166 (2006).



## IV. RULE 145 TRANSACTIONS

*A. In General*

Under Rule 145(a), the issuance of securities in exchange for securities under a reorganization or recapitalization plan which is submitted for security holders' authorization involves an "offer, offer to sell, offer for sale, or sale" of securities, which triggers the registration requirements of the 1933 Act.<sup>102</sup> Rule 145(a) is the embodiment of the above-mentioned "sale" theory.<sup>103</sup> The legislative purpose of Rule 145 is to help the voting security holders to make well-informed investment decisions. If, under a state law, a recapitalization or reorganization is carried out without security holders' approval, it will not fall within the meaning of a Rule 145 type transaction because it leaves no room for helping security holders' investment decisions.<sup>104</sup>

Although Rule 145 indicates that the submission of the proposal for a Rule 145 transaction to a shareholder vote involves a "sale," questions still remain as to what the "sale" is in connection with registration requirements. To qualify as a "sale" for purposes of Rule 145, a security contract or security disposition should meet the definition of a sale within the meaning of Section 2(a)(3) of the 1933 Act. Section 2(a)(3) requires a transaction to be "for value" to involve a sale.<sup>105</sup>

*B. The "For Value" Requirement: The Framework for the Term "Sale"*

As in other transactions under the 1933 Act, the securities to be issued in Rule 145 transactions require registration under Section 5 of the 1933 Act unless exemptions are available. Accordingly, the term "sale" under Rule 145 has the same meaning as the term "sale" used in Section 2(a)(3) of the 1933 Act. Section 2(a)(3) defines the term "sale" as a transaction involving "every contract of sale or disposition of a security or interest in a security, for value."<sup>106</sup> In many cases, the "for value" requirement of Section 2(a)(3) becomes a keyword in the definition of the "sale."

According to Section 2(a)(3), any issuance of securities for no value, such as free stocks, does not involve a sale which triggers the

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102. 17 C.F.R. § 230.145(a) (2006).

103. For a review of "the sale theory and Rule 145," see *supra* Part II.D.

104. See JOHN C. COFFEE, JR. & JOEL SELIGMAN, SECURITIES REGULATION: CASES AND MATERIALS 503 (9th ed. 2003) [hereinafter COFFEE & SELIGMAN, SECURITIES REGULATION].

105. 15 U.S.C.A. § 77b(a)(3) (West 2006).

106. *Id.*

operation of disclosure and anti-fraud provisions of the 1933 Act. However, as a commentator says, “Value Is Not Always What It Seems.”<sup>107</sup> For example, when you get free stocks on condition of mailing to the issuer, the information of your name and address on the envelope may be regarded as consideration of the issuance of free stocks.<sup>108</sup> The term “value” is a flexible and functional concept. The substance of a transaction as a whole is more important than the legal form in determining whether securities are issued “for value.”

In ordinary securities transactions, cash is exchanged for securities. On the other hand, in Rule 145 transactions, existing securities are exchanged for new securities. Thus, in Rule 145 transactions, it is an important issue if the existing security as a consideration has a “different” value from the new securities to be issued. A “material” change in security holders’ rights involves a “sale,” even though it does not take the form of a conventional sale. For example, when an issuance of new securities that is subject to a shareholder vote results in a significant alteration of dividend rights, the shareholders have to make a new investment decision about the exchange of existing securities for substantially changed securities. Therefore, in Rule 145 transactions, the issue of the “for value” requirement to be a “sale” boils down to whether there is a material change in security holders’ rights.

### *C. Transactions Covered by Rule 145*

#### 1. Recapitalizations<sup>109</sup>

Rule 145(a)(1) subjects a “reclassification of securities”<sup>110</sup> to disclosure requirements under Section 5 of the 1933 Act.<sup>111</sup> Rule 145(a)(1) excludes recapitalization in the form of “a stock split, reverse

107. COX ET AL., SECURITIES REGULATION, *supra* note 12, at 395.

108. See, e.g., Andrew Jones and James Rutten, SEC No-Action Letter, 1999 SEC No-Act. LEXIS 555 (June 8, 1999) (stating that the issuance of securities in consideration of a person’s registration with the issuer, whether or not through the issuer’s internet site, would be an event of sale within the meaning of section 2(a)(3) of the Securities Act of 1933).

109. The term “recapitalization” means an “adjustment or recasting of a corporation’s capital structure . . . through amendment of the articles of incorporation . . .” BLACK’S LAW DICTIONARY 1295 (8th ed. 2004). Recapitalizations include the exchange of stock for another class of stock and the exchange of debt for another kind of debt of the same company.

110. Many securities law scholars use the same meaning for “recapitalization” and “reclassification” in Rule 145(a)(1). COX ET AL., SECURITIES REGULATION, *supra* note 12, at 411 (stating that “[t]hree types of Rule 145 transactions . . . are . . . recapitalizations, mergers, and certain transfers of assets . . .”).

111. 17 C.F.R. § 230.145(a)(1) (2006).

stock split, or change in par value” from the definition of “sale.”<sup>112</sup> The exclusion of changes in par value from Rule 145 registrations is a logical conclusion of the “for value” theory. A stock split involves no change in the valuation of stocks, because only the number of stocks is changing according to the exchange ratio of a stock split. Therefore, there is no exchange of different values, no “sale” within the meaning of Section 2(a)(3), and then no “disclosure requirement” under Section 5.<sup>113</sup>

A reverse stock split<sup>114</sup> seems to cause a change in a shareholder’s proportional ownership and thus there may be a worry that it can be used to “squeeze-out”<sup>115</sup> minority shareholders.<sup>116</sup> A securities law scholar argues that “one should be wary of concluding that reverse stock splits, which clearly come within the letter of the exception of Rule 145(a)(1), necessarily involve no sale of a security.”<sup>117</sup> Also, he explains that “[s]hareholders who receive stock in that transaction . . . are voting to receive a materially changed investment contract” and it triggers Rule 145 registration requirements.<sup>118</sup> He has a good point in that it is improper to presume that any reverse stock split does not include a material change in shareholders’ rights.<sup>119</sup>

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112. *Id.*

113. SEC staffs also believe that in such a capitalization “no investor protection purpose would be served by requiring registration.” Rydex Advisor, SEC No-Action Letter, 1998 SEC No-Act. LEXIS 923, at \*12 (Sept. 29, 1998).

114. A securities law expert states that a reverse stock split is “the conventional stock split in reverse—instead of a company amending its charter so as to have more shares authorized and outstanding, the charter is amended so as to reduce dramatically the authorized and outstanding shares.” Paul H. Dykstra, *The Reverse Stock Split – That Other Means of Going Private*, 53 CHI. KENT L. REV. 1, 3 (1976).

115. In *Kiriakides v. Atlas Food Sys. & Servs., Inc.*, the Supreme Court of South Carolina stated:

“Freeze out” is often used as a synonym for “squeeze out.” The term squeeze out means the use by some of the owners or participants in a business enterprise of strategic position, inside information, or powers of control, or the utilization of some legal device or technique, to eliminate from the enterprise one or more of its owners or participants.

541 S.E.2d 257, 267 n.26 (S.C. 2001) (citing F. HODGE O’NEAL & ROBERT B. THOMPSON, O’NEAL’S OPPRESSION OF MINORITY SHAREHOLDERS, § 1.01 at 1 (2d ed. 1999)).

116. Suppose, for example, that each of a few control shareholders have more than 1,000 shares of a company and each of the other minority shareholders has less than 1,000 shares. The major shareholders can decide on a recapitalization of a 1,000 to 1 reverse stock split. As the result, each major shareholder has more than one newly-issued share while minority shareholders retain no share. In this way, the technique used in the squeeze-out is that many minority shareholders are left with a fractional share after a reverse stock split submitted to a shareholder vote and then the company buys out the fractional share to cause substantial change in its stock ownership structure.

117. Campbell, *Rule 145*, *supra* note 11, at 285.

118. *Id.* at 284-85.

119. *Id.* at 284 (arguing that “a reverse stock split may involve a material change in the rights of shareholders, making it unwise to assume that no sale is involved”).

However, a “material change” test should be strictly applied to reverse stock split cases because Rule 145 may not serve as a cost-effective safeguard for the remaining shareholders in a squeeze-out.<sup>120</sup> The SEC proxy rules<sup>121</sup> or the going private rules<sup>122</sup> require mandatory disclosures to protect the minority shareholders of a certain publicly-held company. Even if those rules are not applied, state law fiduciary duties can serve a minority shareholder protection against “going-private.”<sup>123</sup> Given enough mandatory disclosures relating to a squeeze-out, Rule 145 protection, as another layer of mandatory disclosure, may only increase disclosure costs and cause a chilling effect on reasonable reverse stock splits.

## 2. Mergers or Consolidations

Under Rule 145(a)(2), a merger or consolidation requires registration when it involves security holders’ approval and then an issuance of securities.<sup>124</sup> In a Rule 145 merger or consolidation, the submission of the proposal to security holders’ approval is deemed to be an “offer” within the meaning of Section 2(a)(3) of the 1933 Act.<sup>125</sup> Even though the acquiring company does not offer, the target company can make an offer on behalf of the issuer. In a short-form merger, a “sale” is involved only when the minority shareholders of the target have to choose between securities of the acquirer and appraisal rights for dissenters.<sup>126</sup>

120. A securities law practitioner indicates:

[T]he cost to prepare a Form S-4 can often exceed \$ 250,000 and take up to four months to navigate through the SEC review process. Moreover, another cost of filing a Form S-4 that should not be overlooked is the SEC filing fee, which is based on the value of the securities being registered and can be several thousand additional dollars.

Taylor & Jacobsen, *M&A*, *supra* note 84, at 24.

121. 15 U.S.C.A. § 78n (West 2006).

122. Going private transactions are regulated by fiduciary duties at the state level and disclosure requirements at the federal level. *See generally* COX ET AL., *SECURITIES REGULATION*, *supra* note 12, at 959-66.

123. Generally, “[a] going private transaction is a transaction or series of transactions instituted by the controlling shareholders of a publicly held corporation and designed to eliminate or substantially reduce the corporation’s outstanding public equity, thereby returning the corporation to private ownership.” Harold N. Islen, Comment: *Regulating Going Private Transactions: SEC Rule 13e-3*, 80 COLUM L. REV. 782, 782 (1980) (footnote omitted).

124. 17 C.F.R. § 230.145(a)(2) (2006).

125. Therefore, it must meet the registration requirements of Section 5(c) of the 1933 Act. *See* Mann, *Rule 145*, *supra* note 57, at 579.

126. “Because Rule 145(a) is couched in terms of offers arising in connection with a submission for the vote or consent of security holders, short-form mergers not requiring such vote or consent are not within the scope of the Rule.” SEC Securities Act Release No. 5316, *supra* note

Rule 145(a)(2) provides an exception to the registration requirements in mergers or consolidations when “the sole purpose of the transaction is to change an issuer’s domicile solely within the United States . . . .”<sup>127</sup> Any change-of-domicile merger from one state to another state brings about a change in applicable state laws. If the change results in a material change in shareholders’ rights or a “change in the form of legal entity,”<sup>128</sup> the Rule 145(a)(2) exception is not available and registration is required.<sup>129</sup> The “sole purpose” test for the change-of-domicile exception under Rule 145(a)(2) can be interpreted to be functionally equivalent to the “material change” criterion.

“[T]he change of domicile exception does not apply when a change of national jurisdiction is involved”<sup>130</sup> because the change in applicable laws causes a significant change in shareholders’ rights.<sup>131</sup> In 1985, the SEC amended Rule 145(a)(2) to allow the change-of-domicile exception only when the transaction occurred “solely within the United States.”<sup>132</sup> In issuing no-action letters, however, the SEC staff would not like to be bound by the language of Rule 145(a)(2), “solely within the United States.” The staff took a no-action position on a change in domicile within Canada because it would not “effect a change in national

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6, at \*14-5.

127. 17 C.F.R. § 230.145(a)(2) (2006).

128. ROBERT J. HAFT, ANALYSIS OF KEY SEC NO-ACTION LETTERS § 8:4 (2006), *available at* WESTLAW, SECKEYNAL S 8:4 [hereinafter HAFT, NO-ACTION LETTERS]. *See, e.g.*, Producers Chemical Corporation, SEC No-Action Letter, 1975 SEC No-Act. LEXIS 1767, at \*1 (Sept. 4, 1975) (taking the position that “the significant change in the issuer’s organizational structure . . . will result in a material change in shareholders rights and their relationship to the new entry”).

129. In a Release, the SEC took the following view:

Regardless of where the new corporate entity is domiciled, the exception set forth in Rule 145(a)(2) is not applicable [when] the transaction involves a significant change in the form of the issuer’s legal entity and results in a significant change in a security holders’[] economic interest. Accordingly, absent an applicable statutory exemption, the securities issued in the transaction are required to be registered under the Act.

SEC Securities Act Release No. 5463, 1974 SEC LEXIS 3448, at \*13 (Feb. 28, 1974).

130. SEC Securities Act Release No. 33-6535, 1984 SEC LEXIS 1583, at \*37 (May 9, 1984).

131. The SEC staff allowed a company to change its domicile from Canada to Maryland without registration under the 1933 Act. Scudder International Investments, Ltd., SEC No-Action Letter, 1975 SEC No-Act. LEXIS 1354 (July 5, 1975). A few years later, however, the SEC staff did not permit Rule 145(a)(2) exception when a corporation changed its domicile from Delaware to the Cayman Islands. “With specific reference to the change of domicile exception of Rule 145(a)(2), the staff [drew] a sharp distinction between changes of domicile effected entirely within the United States or North America and those involving a change from within the United States to a totally foreign domicile.” Apco Argentina, Inc., SEC No-Action Letter, 1979 SEC No-Act. LEXIS 2211 (Feb. 12, 1979) (citing CACI, Inc., SEC No-Action Letter, 1977 SEC No-Act. LEXIS 2688 (Nov. 14, 1977)).

132. SEC Securities Act Release No. 33-6579, *supra* note 69, at 3\*6; 17 CFR 230.145(a)(2) (2006).

jurisdiction with respect to the Company.”<sup>133</sup> The SEC staff was right in applying the “material change” standard to the change-of-domicile transaction. However, it is undesirable for the SEC staff to extend the change-of-domicile exception through the no-action letter without the revision to the language of Rule 145(a)(2). In 1985, the SEC expressly restricted the change-of-domicile exception through the amendment of Rule 145(a)(2). Therefore, the staff should have narrowly interpreted the exception clause in accordance with the Latin maxim, *exceptio est strictissimae interpretationis*.

In many cases, the change-of-domicile transactions are performed along with reorganizations. The staff allowed the change-of-domicile exception in the change of an investment company’s form from a limited partnership in New York to a corporation in Maryland.<sup>134</sup> However, the staff required registration in the change of a private cooperative stock company from a cooperative form to a corporation form indicating that “[the change-of-domicile] exception cannot be expanded to cover other transactions, such as a change in organizational form, because such transactions often involve significant changes in the rights and responsibilities of shareholders, officers and directors.”<sup>135</sup> The change in organizational form is more likely to change shareholders’ rights when combined with a change of domicile. However, the staff did not explain why the change of domicile makes the change in issuer’s legal entity easier and what the difference between the limited partnership case and the cooperative case is.<sup>136</sup>

### 3. Transfer of Assets and Spin-Offs

The mechanism of a transfer of assets in exchange for stock is complex because the shareholders acquire securities not as a direct result of their individual decision but by a plan or agreement. A transfer of assets in exchange for stocks involves a sale and triggers registration

133. SmarTire Systems, Inc., SEC No-Action Letter, 2001 SEC No-Act. LEXIS 441, at \*1 (March 29, 2001). *See also* Fresenius Aktiengesellschaft, SEC No-Action Letter, 2006 SEC No-Act. LEXIS 637 (Oct. 10, 2006) (applying the change-of-domicile exception to Fresenius’ conversion from German to European corporation).

134. *See* PEMCO, SEC No-Action Letter, 1988 SEC No-Act. LEXIS 635 (May 31, 1988). *See also* Fidelity Exchange Fund, SEC No-Action Letter, 1984 SEC No-Act. LEXIS 2440 (July 23, 1984), *cited in* Campbell, *Rule 145*, *supra* note 11, at 289.

135. Rochester Drug Cooperative, Inc., SEC No-Action Letter, 1973 SEC No-Act. LEXIS 421 (Oct. 5, 1973) (providing that “Rule 145(a)(2) provides an exception from registration only for ‘change of domicile’ transactions” without consideration of any material change in shareholders’ rights), *cited in* Campbell, *Rule 145*, *supra* note 11, at 289 (emphasis added).

136. *See* Campbell, *Rule 145*, *supra* note 11, at 289.

requirements when it meets Rule 145(a)(3)'s requirements.<sup>137</sup> A stock-for-asset transaction without resolution or distribution does not require registration because the company, the asset seller, acquires securities like a private placement.

In a spin-off transaction, a publicly-held company distributes a privately-held subsidiary's stocks to its shareholders to make the subsidiary a publicly-owned company. On its face, the spin-off process does not seem to include a transfer for value by shareholders because the stock distribution in the process is usually made in the form of stock dividend; an ordinary stock dividend does not involve a "for-value" transaction.<sup>138</sup> However, the Court and the Commission<sup>139</sup> have recognized that the spin-off without independent business purpose can

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137. Rule 145(a)(3) provides that a stock-for-asset transaction involves a "sale" if:

- (i) Such plan or agreement provides for dissolution of the corporation or other person whose security holders are voting or consenting; or
- (ii) Such plan or agreement provides for a pro rata or similar distribution of such securities to the security holders voting or consenting; or
- (iii) The board of directors or similar representatives of such corporation or other person, adopts resolutions relative to paragraph (a)(3) (i) or (ii) of this section within 1 year after the taking of such vote or consent; or
- (iv) The transfer of assets is a part of a preexisting plan for distribution of such securities, notwithstanding paragraph (a)(3) (i), (ii) or (iii) of this section.

17 C.F.R. § 230.145(a)(3) (2006).

138. The Second Circuit held that "[a] stock dividend does not distribute property but simply dilutes the shares as they existed before." *Hafner v. Forest Laboratories, Inc.*, 1964 U.S. Dist. LEXIS 8892, at \*13 (S.D.N.Y. 1964), *aff'd*, 345 F.2d 167 (2d Cir. 1965).

Professor Loss said, "it just cuts the same pie into smaller slices." LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATIONS* § 3-A-2 (3d ed. 2001), available at LEXIS, SECURITIES REGULATIONS 3d §3-A-2.

139. In a Release, the SEC stated that:

While the distribution of the shares to the acquiring company's shareholders may not, in itself, constitute a distribution for the purposes of the Act, the entire process . . . can have that consequence. . . . [T]he shares which are distributed in certain spin offs involve the participation of a statutory underwriter and are thus . . . subject to the registration requirements of the [1933] Act. . . .

SEC Securities Act Release No. 4982, 1969 SEC LEXIS 703, at \*2 (July 2, 1969).

Also, in SEC Staff Legal Bulletin No. 4, the Division of Corporation Finance took the position that a spin-off is not subject to the registration requirements of the 1933 Act if it meets the following five requirements:

- (1) The parent shareholders do not provide consideration for the spun-off shares;
- (2) The spin-off must be pro rata;
- (3) The parent must provide adequate information to its shareholders and the trading markets;
- (4) Valid Business Purpose for Spin-Off; and
- (5) If the parent spins-off "restricted securities," the parent must have held those securities for at least two years.

CF Staff Legal Bulletin No. 4 (Sept. 16, 1997), available at <http://www.sec.gov/interp/legals/slb4.txt> (last visited Oct. 25, 2006).

be nothing but a device for the spun-off company to have the trading market or for a private company to go public through the back door.<sup>140</sup> A spin-off, as a transfer of assets, may meet the elements of Rule 145(a)(3) when the shareholders of a selling corporation are asked to vote on the issuance of shares in connection with the spin-off.

Focusing on the entire process of a set of transactions, in *SEC v. Datronics Engineers, Inc.*,<sup>141</sup> the Fourth Circuit held the development of a trading market for the spin-off company's shares as a "value" which constitutes a "sale" and triggers the disclosure requirements under the 1933 Act.<sup>142</sup> The case has a strong significance in that the existence of a trading market has an economic value because the trading market for securities of a private company provides liquidity and increases the value of the securities. However, if the spin-off is not submitted to a shareholder vote, but is decided by the board of directors, it does not involve a "sale."<sup>143</sup> The information provided by the disclosure system of the 1933 Act is for security holders to decide which investment options to pursue. Where a spin-off is approved only by a board of directors and the shareholders have no option, there is no risk that voting shareholders will lack information required to make material investment decisions.<sup>144</sup> The board's approval can be reviewed in terms of fiduciary

140. Historically, many private companies going public without registration assumed the form of a "spin-off shell." In the first phase of the scheme, a publicly-owned company creates a wholly-owned subsidiary and distributes the subsidiary-shell's stocks to the parent company's shareholders. In the second phase, the spun-off subsidiary, which has gone public, is merged with a private company which has already acted in collusion with the parent company to go public without the 1933 Act's regulation. See Leib Orlanski, *Going Public through the Backdoor and the Shell Game*, 58 VA. L. REV. 1451, 1468-69 (1972).

Before the adoption of Rule 145, both phases required no registration - in the first phase due to the "for value" theory and in the second phase thanks to the "no-sale" theory.

141. *SEC v. Datronics Engineers, Inc.*, 490 F.2d 250 (4th Cir. 1973), *cert. denied*, 416 U.S. 937 (1974).

142. *Id.* See also *SEC v. Harwyn Industries Corp.*, 326 F. Supp. 943 (S.D.N.Y. 1971) (holding that the transactions which involved distribution of a subsidiary's unregistered shares through the spin-off scheme to create public trading market of the shares violated the purpose of Section 5 under the 1933 Act).

143. In *Isquith v. Caremark Int'l Inc.*, Judge Posner held that in a spin-off which was not subject to the shareholder approval, "[t]he members of the class did not buy or sell shares in [a parent company]. They did not buy or sell shares in [a spun-off subsidiary]. They simply received one share of [the subsidiary's] stock for every four shares they owned of [the parent company]." 136 F.3d 531, 534 (7th Cir. 1998) (citing *Rathborne v. Rathborne*, 683 F.2d 914 (5th Cir. 1982)). Illustration F in SEC Securities Act Release No. 5463 indicates that shareholders' approval is necessary to trigger Rule 145 registration requirements. See SEC Securities Release No. 5463, *supra* note 1299, at \*15-6. But see Richard J. Morgan, *Offers to Buy Under the Securities Act of 1933*, 1982 ARIZ ST. L.J. 809, 818-21 (1982) (arguing that *Datronics* case involved an offer "to buy" to trigger registration requirements).

144. See Campbell, *Rule 145*, *supra* note 11, at 296-99.



duties. Also, spin-off transactions are also regulated under the 1934 Act and the Penny Stock Reform Act of 1990.<sup>145</sup> Therefore, the reasoning of *Datronics* extended the “sale” concept beyond the legislative scope of the 1933 Act.

The real concern of spin-offs lies in the secondary distribution of securities of a spun-off company to the public without adequate information.<sup>146</sup> Thus, the SEC thinks much of the availability of information concerning the spun-off company in the regulation of spin-offs. The SEC adopted Rule 15c2-11 of the 1934 Act to provide the over-the-counter “pink sheet” market with specified information on companies whose stocks are quoted.<sup>147</sup> Also, as the spin-off scheme can be associated with manipulation of penny stocks, it is regulated by Rule 15g-9’s penny stock suitability requirements<sup>148</sup> and other provisions of the Penny Stock Reform Act of 1990.

#### 4. Exempted Rule 145 Transactions

The preliminary note to Rule 145 provides that “[t]ransactions for which statutory exemptions under the [1933] Act, including those contained in sections 3(a)(9), (10), (11) and 4(2), are otherwise available are not affected by Rule 145.”<sup>149</sup> Accordingly, a reorganization or recapitalization within the meaning of Rule 145 which involves a sale can be exempted from registration requirements under certain exemption provisions: Sections 3(a)(9)<sup>150</sup> and (10)<sup>151</sup>; intrastate offerings exempted

145. The Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 104 Stat. 931 (codified in scattered sections of 15 U.S.C.). Penny Stock Rules consist of Rules 15g-1 through 15g-6, 15g-8 and 15g-9. See SEC Exchange Act Release No. 34-30608, 1992 WL 97553 (April 20, 1992) (adopting Rule 3a51-1 and Rules 15g-1 through 15g-6 pursuant to the Penny Stock Reform Act); SEC Exchange Act Release No. 34-30577, 1992 SEC LEXIS 867 (April 13, 1992) (adopting Rule 15g-8). See also SEC Exchange Act Release No. 34-49037, 2004 SEC LEXIS 45 (Jan. 8, 2004) (proposing amendments to the penny stock rules).

146. “The losers in [a certain spin-off] are those who buy the shares in the trading market without the benefit of disclosure.” GARY M. BROWN, UNDERSTANDING THE SECURITIES LAWS 77 (2006), 1556 PLI/Corp 49.

147. 17 C.F.R. § 240.15c2-11 (2006). See also SEC Exchange Act Release No. 9310, 1971 SEC LEXIS 195 (Sept. 13, 1971).

148. 17 C.F.R. § 240.15g-9 (2006) (providing “[s]ales practice requirements for certain low-priced securities”). See SEC Exchange Act Release No. 34-32576, 1993 SEC LEXIS 1588 (July 2, 1993) (amending Rule 15c2-6 and redesignating it as Rule 15g-9).

149. 17 C.F.R. § 230.145 (2006) (Preliminary Note).

150. Section 3(a)(9) exemption is for a single company recapitalization. See 15 U.S.C. § 77c(a)(9) (2006).

The exemption reflected the economic policy to give an opportunity to make a “fresh start” to companies in financial trouble. COX ET AL., SECURITIES REGULATION, *supra* note 12, at 418-22. Currently, however, Section 3(a)(9) has been used more widely than before, for example, as a legal

by Section 3(a)(11)<sup>152</sup> and Rule 147<sup>153</sup>; private placements or private offerings under Section 4(2)<sup>154</sup> or Regulation D<sup>155</sup>; and small offering exemptions under Regulation A.<sup>156</sup> These exemptions can relieve the chilling effect of Rule 145's registration requirements on business combinations. As exemptions are exceptional in the disclosure system of the 1933 Act, the person who claims the exemption has the burden of proof.<sup>157</sup>

Rule 145 transactions are categorized into registered transactions and exempted transactions. If an issuer meets the requirements of any exempted Rule 145 transaction, he has an option between the exemption and Rule 145 registration. In exemptions associated with Rule 145 type transactions, other investor protection vehicles still exist. Even though issuers are exempted from registration under the 1933 Act, they remain subject to antifraud provisions of Section 12(2) of the 1933 Act and Section 10(b) of the 1934 Act.<sup>158</sup> The submission of those exemptions to a shareholder vote may trigger compliance of proxy rules under Section 14 of the 1934 Act<sup>159</sup> if the securities to be exchanged are registered under Section 12 of the 1934 Act.<sup>160</sup> The resale restriction on securities acquired in an exempted transaction safeguards the public against making uninformed investment decisions.

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tool for "going private" or "poison pills." See J. William Hicks, *Recapitalizations under Section 3(a)(9) of the Securities Act of 1933*, 61 VA. L. REV. 1057, 1060-71 (1975) (explaining a variety of uses of the section 3(a)(9) exemption) [hereinafter Hicks, *Recapitalizations*].

151. Section 3(a)(10) provides an exception to registration for securities acquired in a judicially or administratively approved reorganization or recapitalization. 15 U.S.C. § 77c(a)(10) (2006).

152. Section 3(a)(11) exempts from registration any offer or sale of securities to residents within a single state by an issuer who resides in or is incorporated in the same state and doing business in the state. 15 U.S.C.S. § 77c(a)(11) (LexisNexis 2006).

153. 17 C.F.R. § 230.147 (2006).

154. Registration requirements under Section 5 of the 1933 Act do not apply to "transactions by an issuer not involving any public offering." 15 U.S.C.S. § 77d(2) (LexisNexis 2006).

155. Regulation D consists of three exemptions: the exemption for limited offerings and sales of securities not exceeding \$1,000,000 under Rule 504, the exemption for limited offerings and sales of securities not exceeding \$ 5,000,000 under Rule 505, and the private offering under Rule 506. 17 C.F.R. §§ 230.504-.506 (2006).

156. Even though the language of the preliminary note to Rule 145 does not include Regulation A, the list of exemptions is illustrative, not exclusive. Regulation A is a kind of mini-registration promulgated under Section 3(b) of the 1933 Act. It contains Rules 251-264. *Id.* at §§ 230.251-.264.

157. See 7 J. WILLIAM HICKS, EXEMPTED TRANSACTIONS UNDER THE SECURITIES ACT OF 1933 § 1:10 (2006), available at WESTLAW, SECEXTRANS § 1:1 [hereinafter 7 HICKS, EXEMPTED TRANSACTIONS].

158. See Hicks, *Protection of Individual Investors*, *supra* note 3, at 437.

159. 15 U.S.C.S. § 78n (LexisNexis 2006).

160. *Id.* at § 78l.

*D. A Clear and Predictable Standard for the Definition of “Sale” within the Meaning of Rule 145(a)*

The “sale” is a conceptual tool to trigger the disclosure requirement for the purpose of the 1933 Act. Determining whether a sale is involved in Rule 145 type transactions involves a multi-factor test. First, we should use the above-mentioned “sale” theory and “for value” requirement. Then, we should focus not on the traditional sale concept, but on the “material change” in security holders’ rights that is “functionally equivalent to surrendering the old security for a new one.”<sup>161</sup>

The real problem of the interpretation of Rule 145(a) lies in the lack of a clear standard to determine whether a business combination involving a shareholders’ authority and an issuance of new securities involves a “sale.” The SEC’s interpretations and applications of Rule 145 transactions have been inconsistent. Recently, a securities lawyer made a no-action inquiry for a change-of-domicile exception arguing that “on numerous occasions the Staff has taken a ‘no-action’ position confirming that the Rule 145(a)(2) exception is available where a change in the state of domicile is accompanied by significant revisions in the company’s charter and bylaws . . . .”<sup>162</sup>

Responding to the inquiry, the SEC staff accepted the argument and took a no-action position despite the risk that the proposed reincorporation transaction might significantly alter the shareholders’ rights. Deciding the inquiry, the staff seems to focus on saving unnecessary procedure for the incorporation. The staff might support the following argument in the inquiry that:

[I]f the changes in corporate organization were not instituted in connection with the change of domicile, they could be effectuated . . . at a later date through charter amendment adopted with the same shareholder approval, to which the registration provisions of the Securities Act would not apply. Since the same goals could be achieved in two steps, the exception provided by Rule 145(a)(2) should not be held inapplicable merely because the two steps are more expeditiously and economically combined into a single reincorporation

161. COX ET AL., SECURITIES REGULATION, *supra* note 12, at 399.

162. Russell Corporation, SEC No-Action Letter, 2004 SEC No-Act. LEXIS 488, at \*36 (March 18, 2004) (citing General Electric Capital Corporation, SEC No-Action Letter, 2000 SEC No-Act. LEXIS 757, (July 26, 2000); Community Financial Corporation, SEC No-Action Letter, 1996 SEC No-Act. LEXIS 574 (July 1, 1996)).

procedure requiring shareholder approval.<sup>163</sup>

However, the SEC staff is not empowered to give priority to the procedural efficiency of reincorporation over the Commission's longstanding "material change" test for the purpose of Rule 145's registration requirements.<sup>164</sup> In issuing no-action letters, allowing multiple policy considerations into the judgment of "sale" decreased legal clarity and predictability in the application of Section 5.

The Commission may not want to lose the flexibility in the interpretation and application of Rule 145. However, to maintain the predictability and clarity concerning registration requirements of Rule 145, Rule 145(a) should define a recapitalization or business combination as a "sale" only when the transaction results in "a material change in shareholders' rights."<sup>165</sup> Then, a last critical question remains: What is the "material change?" A securities law scholar suggests the essential elements in judging "materiality" include "changes in distribution of control, rights to share in the profits of the enterprise, limited liability and tax treatment."<sup>166</sup> The "change" should be reviewed in light of economic reality. Accordingly, a change in corporate form without economic alteration does not constitute a "sale."<sup>167</sup> The

163. *Russell*, *supra* note 1622.

164. A securities law scholar supports the SEC staff's "procedural efficiency approach avoiding the two-step process," arguing that:

[If] proposed reincorporation requires compliance with the proxy rules and full disclosure of the impact on stockholder rights plus the required percentage vote of stockholders under the law of the first state, it is entirely consistent with the purposes of Rule 145 to allow the change of domicile exception to apply despite significant alterations in shareholder rights.

HAFT, NO-ACTION LETTERS, *supra* note 1288, at § 8:6. The scholar seems to take the change-of-domicile exception as an exception to the "material change" standard. However, the "sole purpose" test for the change-of-domicile exception is based on the "material change" criterion. More importantly, it is improper for the SEC staff to extend the scope of the change-of-domicile exception through issuing no-action letters going beyond the language of Rule 145(a)(2).

A scholar claims that "[b]y permitting the two steps to be combined into a single transaction exempt under the change-in-domicile exception, the Commission has eliminated the need for expensive and needless corporate procedures." Campbell, *Rule 145*, *supra* note 11, at 287. This author, however, would like to make clear that it is not the SEC but the SEC staff members who have unofficially developed the procedural efficiency rule without a rulemaking process. According to Section 2(b) of the 1933 Act, the Commission can consider "efficiency, competition, and capital formation" as well as investor protection in ruling making concerning Rule 145 issues. 15 U.S.C.S. § 77b(b) (LexisNexis2006). Therefore, if there were a related SEC rule and the SEC staff rightly balanced investor protection and market efficiency, the no-action position in the *Russell* case could be justified.

165. A material change in shareholders' rights includes a material change in corporate structure. See HAFT, NO-ACTION LETTERS, *supra* note 1288.

166. Campbell, *Rule 145*, *supra* note 11, at 289.

167. See, e.g., INDRESCO, Inc., SEC No Action Letter, 1995 SEC No-Act. LEXIS 789 (Oct.

“material change” must be “functionally equivalent to surrendering the old security for a new one.”<sup>168</sup>

## V. RESALE OF RULE 145 SECURITIES

### A. In General

After issuance of securities, subsequent resales by recipients of the securities may also create disclosure concerns of Section 5 under the 1933 Act.<sup>169</sup> The disclosure requirements of the 1933 Act extend their reach to the resale that is a “distribution.”<sup>170</sup> Section 4(1) of the 1933 Act distinguishes an unregulated “trading transaction” from a regulated “secondary distribution.”<sup>171</sup> Under Section 4(1), “transactions by any person other than an issuer, underwriter, or dealer” as “ordinary market transactions” are exempted from the registration requirements of the 1933 Act.<sup>172</sup>

Among issuers, underwriters, and dealers, the term “issuer”<sup>173</sup> has such a literal meaning that it becomes relatively easy to define, and the term “dealer”<sup>174</sup> can be exempted from registration under Sections 4(3) and (4).<sup>175</sup> However, the term “underwriter” is flexibly broad because the federal courts’ and the SEC’s approaches to the “underwriter” concept are based on functional and transaction-based considerations.<sup>176</sup> It can safely be said that the “underwriter” concept determines the scope of Section 4(1) exemption.

31, 1995) (taking an opinion that a change to a holding company structure with the same proportionate interest of shareholders involves no sale).

168. COX ET AL., SECURITIES REGULATION, *supra* note 12, at 399.

169. 15 U.S.C.S. § 77e (LexisNexis2006).

170. Usually, the term “distribution” is used as the same meaning as the term “public offering.” See HICKS, REALES, *supra* note 23, § 3:32.

171. 15 U.S.C.S. § 77d(1) (LexisNexis 2006). See also SEC Securities Act Release No. 5223, 1972 SEC LEXIS 49 (Jan. 11, 1972) (explaining that Section 4(1) “was intended to exempt only trading transactions . . . and not to exempt distributions . . .”).

172. 15 U.S.C.S. § 77d(1) (LexisNexis 2006).

173. *Id.* at § 77b(a)(4).

174. *Id.* at § 77b(a)(12).

175. *Id.* at § 77d(3)-(4).

176. While an investment banker may not be an underwriter, an individual investor can be an underwriter irrespective of a contract or other privities with the issuer if he or she comes within one of Section 2(a)(11)’s categories. In *SEC v. Chinese Consolidated Benevolent Association, Inc.*, the Second Circuit defined a person who solicited offers to buy unregistered Chinese government bonds not for compensation but for patriotic reasons as an “underwriter.” *SEC v. Chinese Consol. Benev. Ass’n, Inc.*, 120 F.2d 738, 741 (2d Cir. 1941), *cert. denied*, 314 U.S. 618 (1941). See also *SEC v. Guild Films Co.*, 279 F.2d 485 (2d Cir. 1960); *SEC v. Culpepper*, 270 F.2d 241 (2d Cir. 1959).

Section 2(a)(11) under the 1933 Act describes the following four categories of underwriters:

(1) “[A]ny person who has purchased from an issuer with a view to . . . the distribution of any security[;]” (2) Any person who “offers or sells for an issuer in connection with[] the distribution of any security[;]” (3) Any person who “participates or has a direct or indirect participation” in an undertaking to distribute any security by the above (1) or (2) activity; or (4) Any person who “participates or has a participation in the direct or indirect underwriting of any such undertaking.”<sup>177</sup>

The above-stated “issuer” includes “any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer” for purposes of determining “underwriter.”<sup>178</sup> Section 2(a)(11) defines anyone who fits into one of the above-mentioned categories as an “underwriter” unless his “interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors’ or sellers’ commission.”<sup>179</sup> The statutory definition of “underwriter” under Section 2(a)(11) covers intermediaries in the securities transfer from the issuer to the public investors. Those intermediaries bear burdens of resale restrictions and Section 11’s liabilities.<sup>180</sup> However, it is not unusual that any participant in a public distribution claims that he is an underwriter because he can get the benefit of Section 2(a)(3).<sup>181</sup> In this context, a securities law scholar comments that “the breadth of Section 2(a)(11)’s definition of underwriter is something of a mixed blessing for those fitting within it.”<sup>182</sup>

Rule 145(c) defines the term “underwriter” differently from the general “underwriter” concept under the 1933 Act.<sup>183</sup> Accordingly, the

177. 15 U.S.C.A. § 77b(a)(11) (West 2006).

178. *Id.*

179. *Id.*

180. *Id.* at § 77k(a).

181. *Id.* at § 77b(a)(3).

182. COX ET AL., SECURITIES REGULATION, *supra* note 12, at 348.

183. Rule 145(c) states:

For purposes of this section, any party to any transaction specified in paragraph (a) of this section, other than the issuer, or any person who is an affiliate of such party at the time any such transaction is submitted for vote or consent, who publicly offers or sells securities of the issuer acquired in connection with any such transaction, shall be deemed to be engaged in a distribution and therefore to be an underwriter thereof within the meaning of section 2[(a)](11) of the Act. The term party as used in this paragraph (c) shall mean the corporations, business entities, or other persons, other than the issuer, whose assets or capital structure are affected by the transactions specified in paragraph

resale of Rule 145 securities partly but significantly deviates from the general resale rule of the 1933 Act. Given both statutory and historical interpretations of the 1933 Act, there is little justification for the different definition of underwriter.

*B. The “Underwriter” Definition under Rule 145(c)*

Rule 145(c) defines as an underwriter any party to any Rule 145 transaction “other than the issuer, or any person who is an affiliate of such party at the time” of the shareholder vote or consent on the transaction.<sup>184</sup> The “underwriter” definition of Rule 145(c) is not theoretically consistent with the general “underwriter” concept of the 1933 Act. The “underwriter” status under Rule 145 is focused only on the control relationship at the time of vote or consent for a Rule 145 transaction without considering various facts<sup>185</sup> showing the purchaser’s investment intent.

Under general resale provisions of the 1933 Act, securities acquired in a registered offering are unrestricted securities,<sup>186</sup> and thus the acquirer can freely resell them unless he or she is a control person of the issuer.<sup>187</sup> However, Rule 145(c) imposes an “underwriter” status on a non-affiliate of the issuer who acquired securities in a registered Rule 145 offering. An affiliate of an acquired company who received unrestricted securities in a Rule 145 transaction and became a non-control person of the issuer is subject to the burdensome resale restriction through the operation of the “underwriter” definition under Rule 145(c).

(a) of this section.

17 C.F.R. § 230.145(c) (2006).

184. *Id.*

185. A review of the SEC staff responses to requests for no-action letters suggests that:

[T]he following factors are relevant in deciding whether a person will be deemed a

statutory [sic] underwriter: (1) Nature of Issuer . . . (2) Trading Volume . . .

(3) Number of Shares Outstanding . . . (4) Quantity of Shares to Be Acquired . . .

(5) Nature of the Offering . . . (6) Relationship Between Recipient and Issuer . . .

(7) Nature of Security . . .

7 HICKS, EXEMPTED TRANSACTIONS, *supra* note 1577, § 9:57.

186. For the definition of restricted securities, see 17 C.F.R. § 230.144(a)(3) (2006). Sales by non-control persons of unrestricted securities do not constitute “distributions” and accordingly the sellers, non-control persons of the issuer, are not “underwriters.” *See id.* § 230.144(b).

187. Rule 405 defines the term “control (including the terms *controlling*, *controlled by* and *under common control with*)” as “the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.” *Id.* at § 230.405 (emphasis added). For the definition of the term “affiliate,” see *id.*

The SEC has been concerned that a control person of a target company dumps a large volume of his new shares on the trading market. As the financial market expanded and the size of the new-issues market increased, it became a serious problem that institutional or other wealthy investors acquired a large block of securities in a public offering and then resold the securities to the public without the burden of prospectus delivery.<sup>188</sup> “[T]o prevent resales of large blocks of securities to the public without requiring the delivery of a prospectus,”<sup>189</sup> the SEC staff extended the “underwriter” concept beyond the statutory patterns under Section 2(a)(11) of the 1933 Act. While the underwriter defined in Section 2(a)(11) is called the “statutory underwriter,” the extended underwriter concept is termed the “presumptive underwriter.”<sup>190</sup> The concept of “presumptive underwriter” was unofficially developed from the SEC’s practice.<sup>191</sup> Practically, however, resale restrictions under the presumptive underwriter doctrine are too burdensome to the big institutional investors.<sup>192</sup> The “underwriter” definition under Rule 145(c) is another variation of the presumptive underwriter doctrine.<sup>193</sup> Thus, the criticisms of the presumptive underwriter doctrine also apply to the “Rule 145 underwriter.”

Adopting Rule 145, the SEC believed that Rule 145 affiliates “usually are in a position to verify the accuracy of information set forth in the registration statement, and usually are in a position to influence

188. See COFFEE & SELIGMAN, SECURITIES REGULATION, *supra* note 104, at 531.

189. 1 HAROLD S. BLOOMENTHAL, GOING PUBLIC HANDBOOK § 2:52 (2006), available at WESTLAW, SECGPH-HB § 2:52.

190. A person may be deemed to be an underwriter, within the meaning of [Section 2(a)(11)] of the Securities Act, if such person purchases or acquires a significant percentage of the securities offered pursuant to a registered distribution, except that such purchaser is not deemed to be an underwriter if he resells such securities in limited quantities.

Robert J. Ahrenholz & William E. Van Valkenberg, *The Presumptive Underwriter Doctrine: Statutory Underwriter Status for Investors Purchasing a Specified Portion of a Registered Offering*, 1973 UTAH L. REV. 773, 775-76 (1973) (footnotes omitted) [hereinafter Ahrenholz & Valkenberg, *The Presumptive Underwriter*].

191. COFFEE & SELIGMAN, SECURITIES REGULATION, *supra* note 104, at 532.

192. Recognizing the problem, the SEC staff accepted the following view:  
[I]nsurance companies and similar institutional investors generally should not be deemed underwriters under Section 2[(a)](11) with regard to the purchase of large amounts of registered securities provided such securities are acquired in the ordinary course of their business from the issuer or underwriter of those securities and such purchasers have no arrangement with any person to participate in the distribution of such securities.

Securities Act of 1933 Section 2(11) Underwriter, SEC No-Action Letter, 1983 SEC No-Act. LEXIS 2542, at \*3 (June 10, 1983).

193. “Rule 145 is the only Securities Act rule that contains a presumptive underwriter provision.” SEC Securities Act Release No. 33-7391, 1997 SEC LEXIS 381, at \*31 (Feb. 20, 1997).



the transaction”<sup>194</sup> and therefore concluded that the Rule 145 “is not unreasonably burdensome.”<sup>195</sup> However, an affiliate of an acquired company in a Rule 145 transaction may have neither enough access to confirm the facts in registration statements, nor competence to influence the transaction. Also, if an affiliate of a target company opposed a proposed business combination transaction, but became the non-affiliate securities holder of the issuer against his or her will after the Rule 145 transaction,<sup>196</sup> the restriction limitation on the person would be unfair.

The underwriter status should be determined considering various factors such as the purpose of purchasing securities and the contractual relationship or other privities with the issuer. The “control relationship” standard of Rule 145(c) is too arbitrary to be consistent with the definition of underwriter under Section 2(a)(11) of the 1933 Act.<sup>197</sup> In 1997, the SEC proposed an amendment to Rule 145 that would eliminate the so-called “presumptive underwriter” and resale limitation provisions treating resales of Rule 145 securities the same as resales of other securities.<sup>198</sup> Soon after the proposal, the SEC staff indicated that “[i]f this proposal is adopted, the staff’s position regarding resale conditions [would] be reassessed.”<sup>199</sup> However, the SEC has yet to amend Rule 145(c).

### *C. Interpretative Problems with Rule 145(c) and (d)*

If a person falls within the “underwriter” definition under Rule 145(c), then Rule 145(d) provides safe harbors for the unregistered resales by Rule 145 affiliates.<sup>200</sup> The underwriter definition of Rule

194. SEC Securities Act Release No. 5316, *supra* note 6, at 20.

195. *Id.*

196. See HICKS, REALES, *supra* note 23, at § 3:21 (citing Norton Simon, Inc., SEC No-Action Letter, 1976 SEC No-Act. LEXIS 2169 (Oct. 8, 1976)).

197. Whereas Rule 145(a) was based on the “sale” theory, Rule 145(c) was formulated on the model of Rule 133(c) which was based on the “no-sale” theory. See *supra* Part II.D. It made Rules 145(c) and (d) inconsistent with general resale provisions of the 1933 Act. See HICKS, REALES, *supra* note 23, at § 3:18 (stating that “[t]he rationale for [Rule 145(c)’s] administrative interpretation of Section 2(a)(11) can be traced to the no-sale theory and Rule 133”).

198. SEC Securities Act Release No. 33-7391, *supra* note 1934, at \*29-32.

199. CF Staff Legal Bulletin No. 3 (July 25, 1997), available at <http://www.sec.gov/interp/legal/slbef3.txt> (last visited Oct. 25, 2006).

200. Rule 145(d) states:

Notwithstanding the provisions of paragraph (c), a person or party specified therein shall not be deemed to be engaged in a distribution and therefore not to be an underwriter of registered securities acquired in a transaction specified in paragraph (a) of this section if:

(1) Such securities are sold by such person or party in accordance with the provisions of paragraphs (c), (e), (f) and (g) of [Rule 144];

(2) Such person or party is not an affiliate of the issuer, and a period of at least one year,

145(c) and the resale safe harbors of Rule 145(d) do not apply to all Rule 145 transactions. The applicable resale rule differs according to different types of transactions: a registered Rule 145 transaction; an exempted Rule 145 transaction under Section 3(a)(9) or (10), Rule 147, or Regulation A; and an exempted Rule 145 transaction under Section 4(2) or Regulation D.<sup>201</sup> Those different resale rules make distributions of Rule 145 securities unnecessarily complex.

### 1. Resales of Registered Rule 145 Securities

Under Rule 145(c), an affiliate of a target company who acquires securities in a Rule 145 transaction becomes an “underwriter” even if the person is the non-control person of the issuer and the primary offering has been registered under Section 5 of the 1933 Act. If the securities holder comes within the “Rule 145 underwriter” definition, the person has a few options for resale: the registration of the secondary offering, the limited resale under Rule 145(d), and the transaction which is not a “distribution.”

If the person does not fall within the Rule 145 underwriter, the person can freely resell the Rule 145 securities. Adopting Rule 145, the SEC explained that “[t]he securities received in a Rule 145 transaction by persons who are neither affiliates of the acquired company nor of the acquiring company are registered securities without restriction on resale.”<sup>202</sup> Even though the surrendered securities in a registered Rule 145 transaction are restricted securities, the registration wipes the resale restrictions off the newly-issued securities.<sup>203</sup>

The following figure explains applicable resale rules according to the status of shareholder of registered Rule 145 securities.

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as determined in accordance with paragraph (d) of [Rule 144], has elapsed since the date the securities were acquired from the issuer in such transaction, and the issuer meets the requirements of paragraph (c) of [Rule 144]; or

(3) Such person or party is not, and has not been for at least three months, an affiliate of the issuer, and a period of at least two years, as determined in accordance with paragraph (d) of [Rule 144], has elapsed since the date the securities were acquired from the issuer in such transaction.

17 C.F.R. § 230.145(d) (2006).

201. Campbell, *Resale*, *supra* note 31, at 1366.

202. SEC Securities Act Release No. 5316, *supra* note 6, at \*20.

203. See SEC Securities Act Release No. 5463, *supra* note 1299, at \*20 (stating that a non-Rule 145 affiliate “is immediately free to resell publicly . . . regardless of whether some of his [or her] . . . common stock was restricted”).

**Figure 1: Applicable Resale Rules to Registered Rule 145 Securities**

Before the Trans- action \ After the Trans- action	Non-Affiliate of the Issuer	Affiliate of the Issuer
	Non-Affiliate of the Target Company	Affiliate of the Target Company
	<b>Freely Resell</b> <sup>204</sup>	<b>Rule 144</b>
	<b>Rule 145(d)</b>	<b>Rule 145(d)</b> <sup>205</sup>

## 2. Resales of Rule 145 Securities Acquired in Certain Exempted Transactions

The resale of Rule 145 securities received in a certain exempted transaction is treated similarly to the resale of registered Rule 145 securities. In an interpretive release, the SEC indicated that:

Rule 145(d) specifically states that it shall be applicable only to registered securities. Notwithstanding the language of the rule, the Division of Corporation Finance, as a matter of discretion, will not recommend any enforcement action to the Commission if the requirements of Rule 145(d) are followed with respect to resales of securities which are issued in a Rule 145 transaction but not registered because of the availability of either the Section 3(a)(9) or 3(a)(10) exemption, or the Regulation A exemption. This position of the staff, however, does not cover resales under any other exemption.<sup>206</sup>

Accordingly, Rule 145(c) and (d) cover the holders who acquired Rule 145 securities not only in a registered transaction, but also in an exempted one: Section 3(a)(9) or (10), or Regulation A. As securities

204. See, e.g., Coastal Int'l., Ltd., SEC No-Action Letter, 1980 SEC No-Act. LEXIS 2573 (Dec. 24, 1980).

205. See HICKS, RESALES, *supra* note 23, at § 3:27.

206. SEC Securities Act Release No. 6099, 1979 SEC LEXIS 968, at \*89 (Aug. 2, 1979).

acquired in those transactions are unrestricted,<sup>207</sup> a non-Rule 145 affiliate can freely resell them.<sup>208</sup>

A Rule 145 affiliate in the exempted transaction has similar options for resale as a typical Rule 145 affiliate has: registration under Section 5 and exemption under Section 4(1) including Rule 145(d). A Rule 145 affiliate is not always in the position to have the issuer file a registration statement for the resale. As the exempted business combination transaction leaves no registration statement, the registration of the resale costs a lot.<sup>209</sup> If the issuer is a non-reporting company under the 1934 Act, it costs much more.<sup>210</sup> Thus, the registration requirement for the resale is unduly burdensome to Rule 145 affiliates.

### 3. Resales of Rule 145 Securities Acquired in Private Offerings

As the exemptions under Section 4(2) and Regulation D are not securities exemptions,<sup>211</sup> but transaction exemptions, the resale of securities acquired in those exemptions should be subject to registration requirements or other available exemptions under the 1933 Act. In an interpretive release, the SEC makes it clear that Rule 145(d) “does not cover resales under any other exemption” than Section 3(a)(9) or 3(a)(10), or the Regulation A exemption.<sup>212</sup> Accordingly, the resale of the securities acquired in private offerings are subject not to Rule 145(c) and (d), but to general resale rules on restricted securities under the 1933 Act.

In the resale of securities acquired in an exempted Rule 145 transaction, the tradability of the securities depends on the nature of the

207. See HICKS, *RESALES*, *supra* note 23, at § 4:55; Campbell, *Resale*, *supra* note 31, at 1359-62.

208. If, in a Rule 145 transaction, the old securities exchanged under Section 3(a)(9) or (10), or Regulation A had resale limitations of intrastate exemption, the resale of the newly-issued securities could be complex. Professor Campbell takes a good example of this type of dual resale limitation:

[A]n affiliate of an acquired company holds securities that are subject to the resale limitations of Rule 147 and that these securities are exchanged in a Rule 145 transaction, which transaction is exempt from registration under section 3(a)(10). The securities received in the Rule 145 transaction continue to be subject to the resale limitations of Rule 147(e) and, because of the affiliate status of the selling shareholder, are subject also to the resale limitations imposed by Rule 145(c).

Campbell, *Rule 145*, *supra* note 11, at 337.

209. See *id.* at 326-27.

210. *Id.*

211. Section 3(a)(2) through 3(a)(8) exemptions are securities exemptions. See Hicks, *Recapitalizations*, *supra* note 15050, at 1107 (explaining that “Section 3(a)(2) through 3(a)(8) exemptions turn on the intrinsic nature of the securities or the impropriety of further governmental regulation”).

212. SEC Securities Act Release No. 6099, *supra* note 2067, at 89.

exempted transaction. As Rule 145 securities acquired in private offerings under Section 4(2) and Regulation D<sup>213</sup> are restricted securities, the holders of those securities can resell the securities by registering the resale or using Section 4(1) or 4(1 1/2) exemption.<sup>214</sup> The resale limitation of surrendered securities in an exempted Rule 145 transaction remains in the newly issued securities.<sup>215</sup> Consequently, it can cause double resale restrictions.

#### *D. Inconsistencies Caused by Rule 145(c) and (d)*

The test for the term “underwriter” under Rule 145(c) and the safe harbor rule from the underwriter status under Rule (d) have the following three systematic problems: inconsistency with the “sale” theory, inconsistency with general resale provisions, and inconsistency with the current trend in the disclosure system under securities laws.

##### 1. Inconsistency with the “Sale” Theory

Considering the legislative history of Rule 133 and its replacement Rule 145, the SEC transplanted Rule 133(c) based on the “no-sale” theory to the Rule 145 system based on the “sale” theory.<sup>216</sup> As mentioned in Section C of Part II, Rule 133, reflecting the “no-sale” theory, had been misused by majority shareholders in a private company to distribute their unregistered shares indirectly through a business combination. To prevent it, Rule 133(c) was drafted, identifying any person in a control relationship with any party who acquired securities “with a view to the distribution thereof” in a Rule 133 transaction as an underwriter.<sup>217</sup> In this sense, the statutory underwriter concept under Rule 133 was a historical necessity. When Rule 145, based on the “sale” theory, replaced Rule 133, the *raison d’être* for special underwriter definition in connection with business transactions disappeared. However, Rule 145(c) was patterned after Rule 133(c) based on the “no-sale” theory,<sup>218</sup> which caused theoretical inconsistencies and practical unfairness.

213. See 17 C.F.R. §§ 230.501-.506 (2006).

214. See generally HICKS, RESALES, *supra* note 23, §§ 6:1-22.

215. See, e.g., Oracle Corp., SEC No-Action Letter, 1985 SEC No-Act. LEXIS 2256, at \*1 (June 17, 1985) (stating that the new securities in exchange for the old securities “as to which resale restrictions exist continue to be so restricted, and that the holding period for the [old] stock may be tacked to that of the [new] stock”).

216. See HICKS, RESALES, *supra* note 23, at § 3:18.

217. SEC Securities Act Release No. 4115, *supra* note 45, at \*3-4.

218. See *supra* Part II.D.

Under Rule 133 reflecting the no-sale theory, the securities received in a Rule 133 transaction were unregistered. However, under Rule 145 reflecting the sale theory, the securities acquired in a Rule 145 transaction must be registered unless exempted. Consequently, the underwriter definition of Rule 145(c) puts excessive restrictions on the resale of registered securities under Rule 145.

## 2. Inconsistency with the General “Underwriter” Concept

Rule 145(c) defined the term “underwriter” too uniformly compared to the general “underwriter” definition provision under Section 2(a)(11) of the 1933 Act. A security holder can be exempted from registration under Section 4(1) of the 1933 Act if he proves that he is not an issuer, underwriter, or dealer. A holder of Rule 145 securities has purchased the securities from an issuer and therefore faces a risk of being an underwriter “who has purchased from an issuer with a view to . . . the distribution of any security”<sup>219</sup> under Section 2(a)(11) of the 1933 Act. By the negative implication of Section 2(a)(11), a security holder can exempt himself from a underwriter status by proving his trading intention. The following figure shows how to avoid an underwriter status.

**Figure 2: How to Avoid an Underwriter Status**

<b>Subjective Exemption</b>	Without a View to Distribute	Resell after an Holding Period
		Proving Investment Intent
<b>Objective Exemption</b>	No Distribution	Private Sale

When an affiliate of a target company opposes a Rule 145 transaction, but the transaction is approved by a majority of shareholders, he or she cannot be presumed to acquire securities with a view to distribute. However, Rule 145(c) unreasonably prevents the Rule 145 affiliate from relying on the Section 4(1) exemption. The affiliate without a view to the distribution is unfairly treated as to his or her resale of securities acquired in the Rule 145 transaction. In addition, the resale restriction may decrease secondary market liquidity for the Rule

219. 15 U.S.C.S. § 77b(a)(11) (West 2006).

145 securities and therefore cause inefficient stock pricing.<sup>220</sup>

### 3. Inconsistency with the Current Trend in Disclosure System

Newly introduced legislation like Sarbanes-Oxley Act of 2002<sup>221</sup> and Regulation FD<sup>222</sup> have enhanced disclosure requirements and expanded the reach of the federal securities laws. The Self-Regulatory Organizations (SROs), such as the national securities exchanges and registered securities associations, require heightened disclosure in their listing contracts. For a non-public company, Rule 15c2-11 of the 1934 Act requires disclosure of specified information about the company including basic financial data to broker-dealers who are publishing quotations in over-the-counter “pink sheet” markets.<sup>223</sup> In this way, the current disclosure system of the securities laws requires more disclosures than that of the early 1970s when the SEC adopted Rule 145.<sup>224</sup> Therefore, the SEC’s over-regulation of the resale of securities acquired in a Rule 145 transaction is no longer necessary.

To solve the above-mentioned problems, Rule 145(c) and (d) should be repealed and general resale provisions under the 1933 Act should be applied to the resale of Rule 145 securities.

## VI. CONCLUSION

Rule 145 is beneficial on the following three points. First, Rule 145 overcomes the “no-sale” theory and subjects certain business combinations to the registration and prospectus delivery requirements of the 1933 Act. It expands the disclosure requirements of the 1933 Act to an area where there were significant loopholes in mandatory disclosure.

220. The registration requirements under Rule 145(a) guarantee more accurate stock pricing and efficient markets. See Nicholas L. Georgakopoulos, *Why Should Disclosure Rules Subsidize Informed Traders?*, 16 INT’L REV. L. & ECON. 417, 417 (1996) (contending “that disclosure rules are justified in ensuring accuracy of prices and that firms would not provide this service without regulation”). However, the resale provision of Rule 145(c) restricts the liquidity of certain registered securities going beyond general resale rules under the 1933 Act. The reasonable pricing mechanism established by Rule 145(a)’s disclosure requirements may be impeded by Rule 145(c)’s resale restrictions.

221. The Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

222. 17 C.F.R. §§ 243.100 et seq. (2006).

223. 17 C.F.R. § 240.15c2-11 (2006). See also SEC Exchange Act Release No. 34-27247, 1989 SEC LEXIS 1772 (Sept. 14, 1989).

224. The new trend requires a continuous disclosure for publicly traded companies. See generally Dale Arthur Oesterle, *The Inexorable March Toward a Continuous Disclosure Requirement for Publicly Traded Corporations: “Are We There Yet?”*, 20 CARDOZO L. REV. 135 (1998).

Second, Rule 145 imposes on an issuer and its control person anti-fraud liabilities in connection with a Rule 145 transaction. Thus, voting shareholders can seek to remedy securities fraud violations relating to a Rule 145 transaction. Third, Rule 145(b) provides a safe harbor for the announcement of a Rule 145 transaction. Accordingly, normal disclosure practices associated with a Rule 145 transaction can be continued without violating Section 5(c)'s "gun jumping" prohibition.

However, there are many theoretical and practical problems associated with the interpretation and application of Rule 145. These problems occur at three stages of securities transactions: excessive and inconsistent "no-action letters"<sup>225</sup> at the transaction planning stage, the unclear standard for the definition of the "sale" as a triggering event at the registration stage, and the unreasonable "presumptive underwriter" concept at the resale stage.

Court decisions and the SEC's interpretations relating to securities law issues are not sufficient to answer most legal inquiries concerning Rule 145 transactions. Given today's highly technical financial environment, experts' interpretations in SEC no-action letters carry important persuasive authority for complicated securities law claims, including Rule 145 cases. Securities market participants take compliance with SEC staff interpretations in no-action letters as the "least costly alternative."<sup>226</sup> Also, the process of issuing a no-action letter is simpler and less burdensome for the SEC.<sup>227</sup> However, the SEC has overly relied on no-action letters instead of rulemaking or interpretive releases.<sup>228</sup>

The SEC's ad hoc approach through no-action letters, combined with the SEC's distinction between the Commission's views and the

225. In the current economic and financial environment, securities transactions are highly technical and complicated. Accordingly, statutory provisions enacted by Congress and the SEC rules and regulations often fail to provide clear-cut guidelines for market participants to follow. Many securities lawyers representing securities market participants would like the Commission to tailor their opinions to particular securities transactions at a business planning stage. The SEC no-action letter satisfies these legal demands. "Notwithstanding their status as unofficial and informal pronouncements, SEC no-action letters have assumed a considerable degree of importance to market participants and their counsel in planning transactions and conducting business." Donna M. Nagy, *Judicial Reliance on Regulatory Interpretations in SEC No-Action Letters: Current Problems and a Proposed Framework*, 83 CORNELL L. REV. 921, 924 (1998) [hereinafter Nagy, *Judicial Reliance*].

226. *Id.* at 957.

227. See generally Thomas P. Lemke, *The SEC No-Action Letter Process*, 42 BUS. LAW. 1019 (1987).

228. See Campbell, *Rule 145*, *supra* note 11, at 342 (arguing that "[m]any of the problems with Rule 145 are due, at least in part, to the Commission's excessive reliance on no-action letters as the principal development vehicle for Rule 145").



staff's views, may guarantee the SEC's flexibility in the interpretation and application of the securities laws relating to similar but distinguishable securities cases.<sup>229</sup> However, the flexibility amplifies the bureaucratic tendencies towards "risk aversion"<sup>230</sup> and "disinclination to adopt or endorse bright-line rules . . . ."<sup>231</sup> In addition, the flexibility on the case-by-case basis has been garnered at the cost of legal stability.

It is not the SEC itself, but only the division staff of the Commission who issues SEC no-action letters. In the closing part of a no-action letter, there are words of caution to the effect that "[a]ny different facts or conditions might require a different conclusion"<sup>232</sup> and the responses only express "the positions of the Divisions . . . and do[] not express any legal conclusions on the questions presented."<sup>233</sup> The SEC's procedural rule separates the Commission's views from the staff's views,<sup>234</sup> and the SEC is not bound by the staff's opinions on particular cases.<sup>235</sup> Given the restricted precedential value of the no-action letter, too many no-action letters relating to Rule 145 cannot serve well as a general interpretive guidance.<sup>236</sup> Rather, they confuse securities market participants in connection with Rule 145 issues. In addition, vacillating staff opinions in no-action letters<sup>237</sup> cause securities practitioners to make more inquiries to the SEC staff, creating a "vicious

229. Professor Langevoort maintains:

[T]he Commission's historic preference for making policy through no-action letters or enforcement rather than through rule-making, and in its niggardly approach to the development of safe harbor rules in areas (like the nonpublic offering exemption under the '33 Act) of considerable statutory ambiguity. The flexibility that is preserved maximizes the effective scope of the Commission's jurisdiction and limits the opportunity for post hoc criticism based on the perception that, as a result of the particular line that it drew, the agency failed to prevent, if not encouraged, some activity that turned out to be socially harmful.

Donald C. Langevoort, *The SEC as a Bureaucracy: Public Choice, Institutional Rhetoric, and the Process of Policy Formulation*, 47 WASH. & LEE L. REV. 527, 531 (1990).

230. *Id.* at 530.

231. *Id.* at 530-31.

232. SanDisk Corp., SEC No-Action Letter, 2006 SEC No-Act. LEXIS 621, at \*3-4 (Sept. 21, 2006).

233. EIG Mutual Holding Company, SEC No-Action Letter, 2006 SEC No-Act. LEXIS 652, at \*5 (Oct. 25, 2006).

234. 17 C.F.R. § 202.1(d) (2006) (providing that "opinions expressed by members of the staff do not constitute an official expression of the Commission's views").

235. If the Commission were bound by informal staff views, the SEC staff's advisory service to the public would shrink. *See Nagy, Judicial Reliance*, *supra* note 225, at 936.

236. According to the separate statement of former SEC commissioner Fleischman in Release No. 28990, "others claiming to be similarly situated can't be allowed to reason from the [no-action] letter to derive general propositions on which the addressee itself could not rely." SEC Exchange Act Release No. 28990, 1991 SEC LEXIS 409, at \*9 (March 20, 1991).

237. *See generally* Campbell, *Rule 145*, *supra* note 11.

circle.”

The SEC should always keep in mind that interpretive releases are better than no-action letters to clarify ambiguous statutory languages in the federal securities laws, rules and regulations.<sup>238</sup> The SEC’s ad hoc approach to Rule 145 transactions through no-action letters is comparable to a cruise without a guiding light. The Commission must give up its no-action letter preference and amend Rule 145 so that the rule may serve as a guiding light for securities market participants and their legal counsel planning a Rule 145 transaction. The amendment to Rule 145 should be consistent with the legislative purposes and general rules of the 1933 Act.<sup>239</sup>

Rule 145(a) rightly answers the legislative purpose of the 1933 Act by extending the “sale” concept to certain business combination transactions, thereby triggering Section 5’s registration and prospectus requirements. However, Rule 145(a) draws too dogmatic a line between “sale” and “no-sale.”<sup>240</sup> Moreover, it fails to provide a clear standard for

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238. It is clear that the Commission’s general position stated in an interpretive release gives more certainty and predictability to financial market players than the SEC staff’s no-action position on a particular transaction. Also, third party reliance is better legally protected on an authorized interpretive release than on a no-action letter. See Richard H. Rowe, *Reliance on SEC Staff “No Action” Letters—A Shield or a Sword?*, in *OPINIONS IN SEC TRANSACTIONS* 681-95 (1995), available at WESTLAW, 896 PLI/Corp 667.

239. The Senate Report on the Securities Act of 1933 provides that “[t]he purpose of this bill is to protect the investing public and honest business.” SENATE COMM. ON BANKING AND CURRENCY, REGULATION OF SECURITIES, S. REP. NO. 47, 73d Cong., 1st Sess. 1 (1933), cited in *United States v. Naftalin*, 441 U.S. 768, 775 (1979). Even though courts hold slightly different views, all courts have the same opinion that “investor protection” is one of important purposes of the 1933 Act. Compare *United States v. Naftalin*, 441 U.S. 768, 775 (1979) (holding that “neither [the Supreme Court] nor Congress has ever suggested that investor protection was the sole purpose of the Securities Act”), with *A.C. Frost & Co. v. Coeur D’Alene Mines Corp.*, 312 U.S. 38, 40 (1941) (holding that investor protection is the “essential purpose” of the 1933 Act), and *Gilligan, Will & Co. v. SEC*, 267 F.2d 461, 463 (2d Cir. 1959), cert. denied, 361 U.S. 896 (1959) (holding that “[t]he principal and essential purpose of the 1933 Act is to protect investors”).

As the Supreme Court stated in *Pinter v. Dahl*, the purpose of investor protection under the 1933 Act is achieved “by requiring publication of material information thought necessary to allow [the investors] to make informed investment decisions . . . .” 486 U.S. 622, 638 (1988).

240. See Campbell, *Rule 145*, supra note 11, at 339 (arguing that “Rule 145 also has been plagued by the breakdown of the categories delineated in section (a) of the Rule”). Cf. Heyman, *Implications*, supra note 32, at 792.

Does the rule imply that any transaction not within its terms is *not* a sale? Is it possible that some transactions which, reading the language of the Rule literally, *are* within its terms are also not sales? Although speculative opinions of the type which will follow are possible, a definitive answer to this question must await future Commission interpretation of Rule 145. It is hoped that such interpretations will prove fully consistent with the policies underlying the Rule.

*Id.*

the determination of whether a “sale” has occurred. Consequently, the SEC’s interpretations and applications of Rule 145(a) are inconsistent and sometimes go beyond the congressional intent of the 1933 Act.

In amending Rule 145(a), the SEC should expressly stipulate the words “material change in security holders’ rights” as a standard for the determination of whether a “sale” is involved.<sup>241</sup> The “material change” standard also leaves a question: what is a “material change” in connection with a certain recapitalization or business combination?<sup>242</sup> The SEC can answer this question through interpretive releases formalizing plenty of its staff interpretations of Rule 145. The language “material change” in the text of Rule 145 serves as a legal basis to prevent the SEC’s ad hoc approach, where the SEC’s policy consideration takes precedence over investor protection and market integrity in the definition of the term “sale.”

The “presumptive underwriter” under Rule 145(c) has lost its historical necessity since the adoption of the “sale” theory. The “underwriter” status, imposed on Rule 145 securities holders under Rule 145(c), unreasonably increases compliance costs and discounts the price of securities due to the lack of liquidity. Resale restrictions are more burdensome to small business issuers. Unless Congress provides new legislative ground for Rule 145 underwriters, Rule 145(c) and (d) must be repealed and the general resale provisions of the 1933 Act must be applied to the resale of Rule 145 securities. It is regrettable that the SEC has not adopted the proposed amendment to Rule 145 in the Release No. 33-7391<sup>243</sup> yet.<sup>244</sup>

241. “Rule 145(a) should state that a reclassification, merger, consolidation or transfer of assets involves a sale of securities to voting shareholders who receive stock in the transaction only if the transaction results in a material change in the corporation or in shareholders’ rights.” Campbell, *Rule 145*, *supra* note 11, at 340.

242. *See supra* Part IV.D.

243. “The presumptive underwriter and resale provisions of Rule 145(c) and (d) are . . . proposed to be eliminated.” SEC Securities Act Release No. 33-7391, *supra* note 1934, at 31.

244. Most securities market participants seem to welcome the proposed revision of Rule 145. A securities company commented on the proposal as follows:

We support the Commission’s proposal in the Release to eliminate the presumptive underwriter doctrine in Rule 145(c) and (d). We do not believe that there is sufficient justification for presuming that holders of securities received in a registered transaction covered by Rule 145 (a “Rule 145 transaction”) that are not affiliates of the issuer of those securities are underwriters for purposes of the Securities Act. If Rule 145(c) and (d) are eliminated, holders of securities received in a Rule 145 transaction that are not affiliates of the issuer of those securities would be free to sell those securities in the open market.

Comments of Robin Roger, Morgan Stanley & Co. Incorporated, New York, May 23, 1997, available at <http://www.sec.gov/rules/proposed/s7797/roger1.htm> (last visited Oct. 25, 2006). *See*

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The above-mentioned amendment to Rule 145 will provide greater clarity and predictability in the registration and resales of Rule 145 securities. Consequently, it will save a lot of billable hours and administrative resources. The societal value of a business combination under Rule 145 lies in efficient resource allocation. In this sense, this author strongly believes that the amendment to Rule 145 and the SEC's clear and predictable interpretation of Rule 145 will encourage efficient recapitalizations and reorganizations by reducing unnecessary regulatory costs.

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*also* Comments of Daniel Dunson, Charles F. Rechlin, Mary Moynihan, and David Rockwell, Sullivan & Cromwell, New York, April 29, 1997 (TEXT REVISED 5-9-97), *available at* <http://www.sec.gov/rules/proposed/s7797/dunson1.htm> (last visited Oct. 25, 2006); Comments of William J. Schnoor, Jr., of Testa, Hurwitz & Thibault, LLP, Boston, Mass., on behalf of the National Venture Capital Association, April 28, 1997, *available at* <http://www.sec.gov/rules/proposed/s7797/schnoor1.txt> (last visited Oct. 25, 2006).